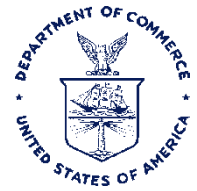


***U.S. DEPARTMENT OF COMMERCE***  
***Office of Inspector General***

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***National Oceanic and  
Atmospheric Administration***

***Audit of Indirect Cost Plans and Rates  
Pacific States Marine Fisheries Commission  
Portland, Oregon***

***Final Report No. OIG-11-025-A  
May 19, 2011***

**FOR PUBLIC RELEASE**

***OIG Office of Audit and Evaluation***






**UNITED STATES DEPARTMENT OF COMMERCE**  
**Office of Inspector General**

Washington, D.C. 20230

May 19, 2011

**MEMORANDUM FOR:** Arlene Simpson-Porter, Director  
NOAA Grants Management Division

**FROM:** Ann C. Eilers   
Principal Assistant Inspector General  
for Audit and Evaluation

**SUBJECT:** *Audit of Indirect Cost Plans and Rates*  
*Pacific States Marine Fisheries Commission*  
*Portland, Oregon*  
Final Report No. OIG-11-025-A

We are attaching a copy of the audit report on the Pacific States Marine Fisheries Commission's indirect cost plans and rates and administrative rates for the fiscal years ending June 30, 2002, through 2008 for your action in accordance with DAO 213-5, "Audit Resolution and Follow-up." This is the first of three related reports. We are currently evaluating the Commission's response to the second draft report, which presents the results of our audit of two NOAA cooperative agreements awarded to the Commission. We expect to issue the third report in final form, presenting the results of our audit of three task orders under a NOAA contract, to the NOAA contracting officer concurrently with the final report to you on the two cooperative agreements.

The original of this indirect cost report has been sent to the Pacific States Marine Fisheries Commission. The Commission has 30 days from the date of the transmittal to submit comments and supporting documentation to you (we have attached a copy of our transmittal letter for your records). A copy of this report will also be made available to the public on the Office of Inspector General (OIG) website.

Under DAO 213-5, you have 75 calendar days from the date of this memorandum to reach a decision on the actions you propose to take on each audit finding and recommendation and to submit an audit resolution proposal to this office. However, because all three of these reports share indirect cost issues, we recommend that you, the NOAA Contracting Officer, and the Department's Indirect Cost Coordinator consider all three reports and collaborate to ensure uniform, consistent resolution proposals and action plans. Therefore, we offer to make the deadline for your response to this report identical to the deadline established for responses to the final cooperative agreement and contract reports.

As applicable, the written proposals must include the rationale and/or legal basis for reinstating any questioned cost in the report and should refer to any supporting documentation relied on. Your comments should also address any funds to be put to better use cited in the reports. Under

the DAO, OIG must concur with your proposal before it may be issued as a final determination and implemented. The DAO prescribes procedures for handling any disagreements we may have with the audit resolution proposal. Please also copy us when the audit determination letter is sent to the auditee and when you issue your accounting notice.

Any information or inquiry regarding this final report should be directed to Jerry McMahan, Assistant Regional Inspector General, at (404) 730-2065, and should reference the report title.

Attachment

cc: Barry Berkowitz, Senior Acquisition Executive and Director, Office of  
Acquisition Management  
Mitchell J. Ross, Director, NOAA Acquisition and Grants Office  
John Stein, Ph.D., Acting Science Director, NOAA/NWFSC  
Susan Sherrell, Director, NOAA Western Acquisition Division  
William Stelle, Jr., Regional Administrator, NOAA/NMFS NWR  
Mack Cato, Director, NOAA Audit and Information Management Office



**UNITED STATES DEPARTMENT OF COMMERCE**  
**Office of Inspector General**  
Washington, D.C. 20230

May 19, 2011

Mr. Randy Fisher, Executive Director  
Pacific States Marine Fisheries Commission  
205 SE Spokane Street, Suite 100  
Portland, OR 97202

Dear Mr. Fisher:

Enclosed is a copy of our final audit report concerning the Commission's indirect cost plans and rates and administrative rates for the fiscal years ending June 30, 2002, through 2008. We evaluated and considered your March 18, 2011, response to the draft audit report in preparation of this final report. Your response, excluding the 18 attachments, appears at appendix C; a synopsis of your response and our comments is also included as appendix D. Copies of the attachments are on file at our office and will be made available for review upon request. A copy of this final audit report will also be made available to the public at OIG's website.

This letter is notice of your opportunity and responsibility to review the report and develop a complete response that addresses each audit finding and recommendation. If you believe the final report is in error in any respect, or if you disagree with any of the findings and recommendations, it is important that you explain the error or your reasons for disagreement and submit to the department evidence that supports your position. You should also explain how each documentary submission supports the position you are taking; otherwise, we may be unable to evaluate the information.

Your complete response will be considered by the Department in arriving at a decision on what action to take with respect to the findings and recommendations in the audit report. Enclosure 1 is an explanation of applicable administrative dispute procedures.

Your response to this report must be postmarked no later than 30 days from the date of this letter. There will be no extensions to this deadline. If you do not submit a response within the required time frame you will have no other opportunity to submit comments, arguments or documentation before the Department makes a decision on the audit report. Please send your response (including documentary evidence) to:



Arlene Simpson-Porter, Director  
NOAA Grants Management Division  
Silver Spring Metro Center Building 2 (SSMC2)  
9<sup>th</sup> Floor  
1325 East-West Highway  
Silver Spring, MD 20940-3280

Please send a copy of your response to:

Jerry McMahan, Assistant Regional Inspector General for Audits  
United States Department of Commerce  
Office of Inspector General  
401 W. Peachtree Street NW, Suite 2742  
Atlanta, GA 30308

If you have any questions about the final report or the audit process, please call Jerry McMahan at (404) 730-2065 and refer to this report's title.

Sincerely,



Ann C. Eilers  
Principal Assistant Inspector General for  
Audit and Evaluation

Enclosures

cc: Barry Berkowitz, Senior Acquisition Executive and Director, Office of  
Acquisition Management  
Mitchell J. Ross, Director, NOAA Acquisition and Grants Office  
Susan Sherrell, Director, NOAA Western Acquisition Division  
Mack Cato, Director, NOAA Audit and Information Management Office

**NOTICE TO AUDITEE**  
**Financial Assistance Audits**

1. Audit requirements applicable to a particular financial assistance award may be established by law, regulation, policy, or the terms of the recipient's financial assistance agreement with the Department of Commerce.
2. The results of any audit will be reported to the bureau or office administering the financial assistance award and to the recipient/auditee, unless the Inspector General of the Department determines that it is in the Government's interest to withhold release of the audit report.
3. The results of an audit may lead to adverse consequences for the auditee, including but not limited to the following actions (which are subject to applicable laws and regulations):
  - suspension and/or termination of current awards;
  - referral of identified problems to other federal funding agencies and entities as deemed necessary for remedial action;
  - denial of eligibility for future awards;
  - canceling the authorization for advance payment and substituting reimbursement by check;
  - establishment of special conditions in current or future awards; and,
  - disallowance of costs, which could result in a reduction in the amount of federal payments, the withholding of payments, the offsetting of amounts due the Government against amounts due the auditee, or the establishment of a debt and appropriate debt collection follow-up (including referrals to collection agencies).

Because of these and other possible consequences, an auditee should take seriously its responsibility to respond to audit findings and recommendations with explanations and evidence whenever audit results are disputed and the auditee has the opportunity to comment.

4. To ensure that audit reports are accurate and reliable, an auditee may have the following opportunities to point out errors (of fact or law) that the auditee believes were made in the audit, to explain other disagreements with audit findings and recommendations, to present evidence that supports the auditee's positions, and to dispute final recommendations:
  - During the audit, the auditee may bring to the attention of the auditors at any time evidence which the auditee believes affects the auditors' work.

- At the completion of the audit on-site, as a matter of courtesy, the auditee is given the opportunity to have an exit conference to discuss the preliminary audit findings and to present a clear statement of the auditee's position on the significant preliminary findings, including possible cost disallowances.
- Upon issuance of the draft audit report, the auditee may be given the opportunity to comment and submit evidence during the 30-day period after the transmittal of the report. (There are no extensions to this deadline.)
- Upon issuance of the final audit report, the auditee is given the opportunity to comment and to present evidence during the 30-day period after the transmittal of the report. (There are no extensions to this deadline.)
- Upon issuance of the Department's decision (the "Audit Resolution Determination"), on the audit report's findings and recommendations, the auditee has the right to appeal for reconsideration within 30 calendar days after receipt of the Determination letter if monies are due the government. (There are no extensions to this deadline.) The Determination letter will explain the specific appeal procedures to be followed.
- After an appeal is filed, or after the opportunity for an appeal has expired, the Department will not accept any further submissions of evidence concerning an auditee's dispute of the Department's decisions on the resolution of the financial assistance audit. If it is determined that the auditee owes money or property to the Department, the Department will take appropriate collection action but will not thereafter reconsider the merits of the debts.
- There are no other administrative appeals available in the Department.



# Report In Brief

U.S. Department of Commerce Office of Inspector General

May 19, 2011



## Background

The Pacific States Marine Fisheries Commission is a quasi-governmental organization operating under an interstate compact authorized by federal statute. It is composed of five member states (Alaska, California, Idaho, Oregon, and Washington) that work together to better utilize and protect the resources of fisheries under their jurisdictions.

Most of the Commission's funding comes from the administration of federal contracts and financial assistance agreements related to fisheries resource management. Since 2003 the Department of Commerce has provided most of the Commission's federal funding and has acted as its *cognizant federal agency*. In this capacity, the Department is responsible for reviewing, negotiating, and approving the Commission's indirect cost rates.

## Why We Did This Review

Federal cost principles require governmental units desiring to claim indirect costs under federal awards to prepare rate proposals, certifications, and specified documentation. These principles also set forth the rules for developing, supporting, and negotiating acceptable indirect cost rates. In addition, Commerce policy requires that acceptable indirect cost rates be developed by grantees and included in approved award budgets.

During the audit period (July 1, 2001, through June 30, 2008), the Commission recovered more than \$15 million in indirect costs, as well as almost \$3 million in administrative fees. The main objective of our audit was to determine whether the Commission complied with federal cost principles and departmental requirements for recovering indirect costs.

## National Oceanic and Atmospheric Administration

### ***Audit of Indirect Cost Plans and Rates Pacific States Marine Fisheries Commission Portland, Oregon (OIG-11-025-A)***

## What We Found

The Commission did not comply with the minimum requirements necessary to recover indirect costs under federal awards. We found significant deficiencies in every area of indirect cost we tested. The Commission did not submit, certify, or adequately support its indirect cost rate proposals. In addition, the Commission's unsubmitted indirect cost proposals and rates were not allowable in accordance with federal guidelines in that (1) implementation of its cost accounting system was inadequate; (2) it had not established an adequate indirect cost methodology or policies, procedures, and controls; (3) its method of distributing costs was inequitable; and (4) it had not adjusted proposed indirect cost rates to reflect actual costs. Therefore, all indirect costs claimed by the Commission during the audit period are called into question; none of the \$15.6 million in costs or the \$2.9 million in administrative fees recovered by the Commission during the audit period is allowable for federal participation.

## What We Recommended

Because the Department acts as the Commission's cognizant federal agency, we directed our recommendations to the NOAA Grants Officer:

1. Require the Commission to comply with minimum federal standards for financial management, such as improving its cost accounting system; establishing adequate indirect cost policies; and developing and documenting indirect cost rate proposals and supporting documentation.
2. Establish a deadline for the Commission to develop and submit revised indirect cost plans and certifications in accordance with federal cost principles and department policies, and recover any excess amounts claimed by the Commission.
3. Suspend payment of indirect costs under all current awards and prohibit recovery for future awards until the Commission develops and negotiates acceptable indirect cost rates.
4. Advise the Commission that its unsupported fees and assessments are unallowable for federal participation on all current and future awards, and require the Commission to identify and remit all such assessments claimed from 2002 to the present.
5. Advise the Department's Indirect Cost Program Coordinator in the Office of Acquisition Management of the results of this audit and our recommendations. The Department, in its cognizant agency role, should then immediately notify all of its bureaus as well as other federal agencies that have provided federal financial and acquisition assistance to the Commission from 2002 through the present.



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## **Introduction**

The Pacific States Marine Fisheries Commission is a quasi-governmental organization operating under an interstate compact authorized by federal statute in 1947. It is composed of five member states (Alaska, California, Idaho, Oregon, and Washington) that work together “to promote the better utilization of fisheries, marine, shell, and anadromous, which are of mutual concern, and to develop a joint program of protection and prevention of physical waste of such fisheries in all of those areas of the Pacific Ocean and adjacent waters over which the compacting states jointly or separately now have or may hereafter acquire jurisdiction.”<sup>1</sup> Its principal offices are located in Portland, Oregon.

Outside of nominal state membership dues and some funds received under agreements with states, most of the Commission’s funding comes from the administration of federal contracts and financial assistance agreements related to fisheries resource management. From 2002 through 2009, approximately 89 percent of the Commission’s revenue came from federal financial assistance and contracts. Since 2003 the Department of Commerce has provided the majority of the Commission’s federal funding and has held cognizant federal agency status for indirect cost rate negotiation. In this capacity, the Department is responsible for reviewing, negotiating, and approving the Commission’s indirect cost rates. These rates apply to all federal agencies providing funds to the Commission unless prohibited or limited by statute.<sup>2</sup>

This report presents the results of our audit of the Commission’s indirect cost plans, claimed rates, and administrative assessments for its fiscal years ending June 30, 2002, through June 30, 2008.<sup>3</sup>

During the audit period (July 1, 2001, through June 30, 2008), the Commission recovered \$15,635,147 of indirect costs—\$8,532,322 from Commerce and \$7,102,825 from other federal agencies. The Commission also recovered \$2,885,365 in administrative fees—\$2,116,782 from Commerce and \$768,583 from other federal agencies. The objectives of our audit were to determine whether the Commission’s indirect cost and administrative assessment rate computations

1. were supported by and consistent with certified indirect cost proposals and established rate negotiations;
2. produced an equitable allocation of costs to projects and activities;
3. were allowable in accordance with the requirements of Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*;

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<sup>1</sup> *Pacific States Marine Fisheries Commission Compact*, Article I.

<sup>2</sup> OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, attachment E at E.1. and 3.

<sup>3</sup> The results of this indirect cost audit will be used as the basis for questioning indirect cost claimed by the Commission under NOAA cooperative agreement numbers NA17FN2284 and NA17FN2536. These agreements cover the periods February 1, 2002, through June 30, 2006, and June 1, 2002, through August 31, 2007, respectively. We will issue a separate audit report covering these agreements.

4. were appropriately and consistently applied; and
5. were adjusted when appropriate.

See appendix A for details regarding our audit objectives, scope, and methodology.

We found the Commission did not comply with the minimum requirements necessary to recover indirect costs under federal awards. Therefore, all indirect costs claimed during the audit period are called into question. The details of our findings are described in the following pages. Numerous examples of unallowable costs, unsupported costs, inconsistently treated expenses, and direct costs treated as indirect are included as appendix B.

On March 18, 2011, the Commission responded to our draft report with comments and supporting documentation, which we have evaluated and considered in preparation of this final report. Due to the volume of the response, we included only the full text of the Commission's cover letter at appendix C; we provided our comments in appendix D. A copy of the Commission's complete response, including 18 attachments, is available for review at our office.

## **Findings and Recommendations**

Federal cost principles require governmental units desiring to claim indirect costs under federal awards to prepare indirect cost rate proposals, certifications, and specified documentation. These principles also set forth the rules for developing, supporting, and negotiating acceptable indirect cost rates.<sup>4</sup> In addition, Department of Commerce policy stipulates that indirect costs are not recoverable under the Department's financial assistance awards unless they are supported by acceptable indirect cost rates developed in accordance with federal cost principles and authorized by inclusion in approved award budgets. Department policy also limits indirect cost recovery to the lesser of (1) the amount authorized in the approved award budget, or (2) the federal share of the total indirect cost allocable to the award computed using the indirect cost rate approved by a cognizant or oversight federal agency and current at the time the cost was incurred (provided that the rate used was approved on or before the award end date).<sup>5</sup>

The Commission did not comply with the minimum requirements necessary to recover indirect costs under federal awards. It did not submit, certify, or adequately support its indirect cost rate proposals. In addition, the Commission's unsubmitted indirect cost proposals and rates were not allowable in accordance with OMB Circular A-87 in that (1) implementation of its cost accounting system was inadequate; (2) it had not established an adequate indirect cost methodology or policies, procedures, and controls; (3) its method of distributing costs was inequitable; and (4) it had not adjusted proposed indirect cost rates to reflect actual costs. Therefore, all indirect costs claimed by the Commission during the audit period are called into question.

### **I. The Commission Did Not Submit, Certify, or Adequately Support Indirect Cost Rate Proposals**

The Commission retained its indirect cost proposals on file rather than submitting them to the Department of Commerce, despite the National Oceanic and Atmospheric Administration (NOAA) Grants Officer's multiple requests for the proposals. In addition, except for the certification of its fiscal year 2007 indirect cost rate, which was submitted to the Department of Commerce on May 1, 2008—several months beyond the 6-month deadline—the Commission had not prepared, signed, or submitted indirect cost rate certifications for fiscal years 2002 through 2008.<sup>6</sup> Thus, none of the indirect cost rates the Commission used to recover \$15.6 million (with over half of that amount for Commerce) during those years had been

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<sup>4</sup> OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, attachment E.

<sup>5</sup> This departmental policy appears in all of the editions of its *Financial Assistance Standard Terms and Conditions* applicable to the audit period. In December 2007 and April 2008, Commerce issued an updated and expanded indirect cost policy specifically requiring annual submission of indirect cost certificates to include not only the provisions of OMB Circular A-87, attachment E at D.3., but also to make the certificates subject to the provisions of the Program Fraud Civil Remedies Act of 1986 (31 U.S.C. § 3801 *et seq.*), the False Claims Act (31 U.S.C. § 3729 *et seq.*), and 18 U.S.C. § 1001 and 18 U.S.C. § 287, prohibiting false statements.

<sup>6</sup> During our audit fieldwork in late March 2009, the Commission submitted a certificate of indirect cost and administrative fees along with its indirect cost rate proposal for fiscal year 2008 in support of financial assistance applications for fiscal year 2009.

negotiated or accepted by the Department for use by all federal agencies, and only one had been certified.

***A. The Commission Did Not Submit Indirect Cost Proposals to the Department***

In 1996 the Commission negotiated an indirect cost rate agreement with the Bonneville Power Administration, a component of the Department of Energy, which at that time was the Commission's cognizant federal agency for indirect costs. The agreement established fixed indirect cost rates with carry-forward provisions for the Commission's fiscal years 1993 through 1997, and then lapsed. Starting in 2003, based on its providing the majority of the Commission's federal funding, Commerce assumed federal agency cognizance for the Commission.

Federal cost principles do not require governmental entities such as the Commission to submit indirect cost proposals unless requested by their cognizant agency.<sup>7</sup> However, Department conditions specifically required the Commission to submit the "documentation (indirect cost proposal, cost allocation plan, etc.)" necessary to evaluate its indirect cost methodology or negotiate a fixed indirect cost rate, and directed that a copy of the letter transmitting the submission also be sent to the NOAA Grants Officer.<sup>8</sup> Subsequent updates of the standard conditions issued in 2005, 2007, and 2008 also required grant recipients to submit indirect cost proposals annually within 6 months after the close of the recipients' fiscal years.<sup>9</sup> The Grants Officer repeatedly noted that the Commission's negotiated indirect cost rate had expired and directed the Commission to comply with *Department of Commerce Financial Assistance Standard Terms and Conditions* regarding indirect costs.

***B. The Commission Did Not Certify Indirect Cost Proposals***

In addition to setting forth the specific documentation required to support indirect cost rate proposals, federal cost principles

- require state and local recipients to prepare and sign indirect cost certificates to accompany the proposals, and
- permit the Department to disallow all indirect cost when the recipient has not submitted a certified proposal in accordance with requirements.<sup>10</sup>

Commerce's *Financial Assistance Standard Terms and Conditions* also require recipients for which the Department is cognizant to submit indirect cost proposals and supporting documentation and certifications for review and negotiation of rates.

Indirect cost certifications attest that the recipient properly prepared its indirect cost rate proposal in accordance with award terms and conditions and federal cost principles. In addition,

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<sup>7</sup> OMB Circular A-87, attachment E at D.1.b.

<sup>8</sup> *Department of Commerce Financial Assistance Standard Terms and Conditions* (2001 and 2004) at A.05.c.1. and (2005 and 2007) at A.05.c.1 (a) and c.1.2.

<sup>9</sup> *Department of Commerce Financial Assistance Standard Terms and Conditions* (2005, 2007, and 2008) A.05.c.3.

<sup>10</sup> OMB Circular A-87, attachments A at H and E at D.3.



certifications assert that unallowable costs have been properly excluded from the indirect cost pool and documented in the cost allocation plan. The certifications specifically provide that

- all costs are properly allocable to federal awards on the basis of a beneficial or causal relationship,
- the same costs have not been claimed both as direct and indirect,
- similar types of costs have been accounted for consistently within and between accounting periods, and
- the federal government will be notified of any accounting changes that would affect the predetermined rates.<sup>11</sup>

Commission personnel stated that they had tried to submit their indirect cost proposals for review but had been told, despite award provisions and the Grants Officer's directions to the contrary, that the Commission had only to retain its indirect cost rate proposals on file in the event of an audit. The Commission did not provide evidence that the NOAA Grants Officer had granted it an exemption from award terms and conditions.

***C. The Commission Did Not Retain Required Documentation in Support of Its Indirect Cost Plans***

The Commission retained its indirect cost rate proposals for 2002 through 2008 on file. However, it had not developed and retained the required documentation in support of its proposals.<sup>12</sup> The Commission lacked

- subsidiary worksheets and other relevant data, cross referenced and reconciled to supporting financial data;
- copies of financial data (such as financial statements, comprehensive annual financial report, executive budgets, accounting reports) upon which the rate is based;
- the approximate amount of direct base costs incurred under federal awards, broken out between salaries and wages and other direct costs;
- organization charts documenting the Commission's organization structure for the proposal periods; and
- functional statements describing the duties and responsibilities of all Commission units.<sup>13</sup>

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<sup>11</sup> In December 2007 and April 2008, Commerce issued updated and expanded indirect cost policy specifically requiring annual submission of indirect cost certificates to include not only the provisions of OMB Circular A-87, attachment E at D.3., but also to make the certificates subject to the provisions of the Program Fraud Civil Remedies Act of 1986 (31 U.S.C. § 3801 *et seq.*), the False Claims Act (31 U.S.C. § 3729 *et seq.*), and 18 U.S.C. § 1001 and 18 U.S.C. § 287, prohibiting false statements.

<sup>12</sup> OMB Circular A-87, attachments E at B.1 and 2, D.1.a., and D.2.a. through d.

<sup>13</sup> OMB Circular A-87, attachment E at D.2.

## **II. The Commission's Unsubmitted Indirect Cost Proposals were Inadequate, and Rates and Claims Were Unallowable**

The Commission did not follow required procedures for submitting, supporting, and certifying its indirect cost proposals. While it retained proposals in support of its claimed indirect cost rates for 2002 through 2008 on file, our initial tests of the Commission's indirect cost proposals disclosed that the proposals were so deficient as to be unauditably. We suspended our audit to provide the Commission the opportunity to develop an indirect cost methodology and cost policy and to prepare adjusted rate proposals. However, when we resumed the audit nearly 2 months later, testing disclosed that the proposals, rates, and indirect costs claimed remained unallowable because the Commission

- based its rate development on an inadequate cost accounting system;
- had not developed adequate indirect cost methodology, policies, procedures, or controls;
- used an indirect cost method that failed to equitably distribute indirect costs; and
- failed to adjust fixed indirect cost rates to reflect actual costs.

Consequently, we concluded that the indirect cost rates claimed were inadequately supported; included unallowable, unsupported, inconsistently treated, and duplicative costs; and failed to ensure equitable distribution of indirect costs to projects and programs in proportion to the benefits received.

### ***A. The Commission's Cost Accounting System Was Inadequate***

The Commission administers numerous projects and activities. Developing an acceptable indirect cost proposal and accurately tracking and reporting the financial results of each project and activity requires an adequate, accurate cost accounting system. While the Commission's automated accounting system appeared to offer the necessary cost accounting framework, its underlying costing policy, which defined projects and costs as direct or indirect and provided for identification and segregation of allowable and unallowable costs, was not clearly drawn or consistently implemented. In addition, key controls over the cost accounting system were either unavailable or overridden. We found that

- direct projects were misidentified as indirect activities;
- costs were improperly shifted from one direct project to another;
- costs were misclassified, unallowable, unsupported, or inconsistently identified as direct or indirect; and
- ancillary rates and fees duplicated or adversely affected the allocation of indirect costs.

***Direct Projects Were Misidentified as Indirect Activities.*** Review of the Commission's indirect cost rates and conversations with staff revealed several activities that had been charged to the indirect cost pool, but which were in fact direct activities that should have been assigned direct project codes and assessed a fair share of indirect costs rather than being allocated to other direct projects. For example, financial and executive personnel administered two fisheries disaster

programs totaling \$230 million; front office staff engaged in event planning; accounting staff performed bookkeeping for the Pacific Fisheries Management Council; and, early in the audit period, accounting staff operated the Commission's building rental activities.

These costs should have been charged to direct costs but were incorrectly charged to indirect costs. Therefore, the costs and related revenues associated with the Commission's actual management and administration of these activities could not be readily isolated. Each of the cited activities constituted a specific direct project that warranted a project number to which all related expenses and revenues should have been charged; each activity should also have been included in the Commission's modified total direct cost base and absorbed its fair share of indirect cost. Miscoding of projects and activities not only overstated the Commission's indirect costs and understated direct costs; it resulted in distributing the costs to projects that received no benefits from them. It also precluded an accurate management assessment of the financial results of individual projects and activities, as well as the financial results of overall Commission operations.

***Costs Were Improperly Shifted from One Direct Project to Another.*** During our concurrent audit of two large NOAA cooperative agreements awarded to the Commission, we noted that it did not always allocate labor and fringe benefits to projects based on the hours employees recorded in its time distribution systems. These systems were capable of identifying time charged to projects and activities, but the Commission improperly shifted labor and fringe benefits from one direct project to another. Because the Commission allocated indirect costs to projects and activities using a total modified direct cost base, which includes direct labor and related fringe benefits, these shifts among projects resulted in inequitable allocations of indirect costs.

***Costs Were Misclassified, Unallowable, Unsupported, or Inconsistently Identified as Direct or Indirect.*** Commission management had a documented system of policies and procedures for some administrative processes. However, the processes and controls necessary to ensure proper identification and classification of costs as direct or indirect and allowable or unallowable were missing or not consistently followed. Our tests of the Commission's indirect cost pools for fiscal years 2002 through 2008 disclosed numerous examples, which are detailed in appendix B, of unallowable costs, unsupported costs, inconsistently treated expenses, and direct costs treated as indirect.

***Ancillary Rates and Fees Duplicated or Skewed Indirect Cost Allocations.*** The Commission also applied ancillary rates and fees to recover elements of cost that it contended were not recovered (in whole or in part) by applying its indirect cost rate. Commission management stated that in select cases, such as the fisheries disaster awards and some projects funded by the State of California, sponsoring agencies would not permit the Commission to directly charge the awards for administrative or management services. Therefore, the Commission resorted to applying a 2 percent administrative assessment to the fisheries disaster monies and assessing a management fee for California-sponsored projects to recoup these costs. The Commission also assessed the 2 percent administrative assessment on other pass-through funds and levied a data-processing fee on select projects and indirect activities in several of the years audited. Our review disclosed that the 2 percent administrative rate was unsupported and that it duplicated the Commission's indirect cost recoveries; and the administrative, management, and data processing assessments all caused an inequitable distribution of indirect costs to projects:

- *Administrative Assessments* - The Commission applied a 2 percent administrative assessment to two fisheries disaster programs funded by two NOAA awards totaling \$230 million. While the Commission recorded the administrative assessments and the revenues received, its project cost accounts did not identify, track, and account for the actual administrative costs incurred as a related direct project expense. Rather, the related expenses were recorded in the indirect cost pool.

Similarly, the Commission also applied a 2 percent administrative assessment to pass-through monies of direct-billed projects, ostensibly to recover the costs of accounting, procurement, and management of the pass-through activities. As with the fisheries disaster awards, the Commission had no support for the rationale, methodology, or development of the 2 percent rate; therefore, the assessments on pass-through funds, like those for the fisheries disaster awards, are unallowable for federal participation.<sup>14</sup> In aggregate, the Commission collected nearly \$2.9 million in administrative assessments during the period under audit—\$2.1 million from Commerce and \$768,583 from other federal agencies.

- *Management Fees* - In lieu of directly charging for labor and related expenses, the Commission assessed management fees to cover its oversight of a number of projects funded by the State of California. The management fees were assessed based on the contractual agreement without adjusting for actual expenditures. The difference between the management fees received and the related expenses incurred for these direct projects was inappropriately included in the indirect cost pool and affected the calculation of the indirect cost rate. Therefore, the net costs were improperly allocated among all the Commission's direct projects via the Commission's indirect cost rate. During the fiscal periods under audit, the annual net increase in the indirect cost pool ranged from \$12,999 to \$112,567.
- *Data Processing Fees* - The Commission charged select direct projects and indirect activities for data processing services, using budget projections of data processing costs and estimates of expected usage. Revenues received based on these projections, as well as actual data processing expenses incurred, were included in the Commission's indirect cost pool. The Commission did not perform a year-end reconciliation of estimates to actual data processing cost and usage as required by OMB guidance.<sup>15</sup> As a result, like the management fees the Commission applied to California-sponsored projects, the net funds were distributed to all direct projects via the Commission's indirect cost rate. Without a reconciliation of budgeted assessments to actual expenses and usage, and adjustment of the data processing charged directly to projects, there is no assurance that the difference was equitably distributed. The Commission followed this practice for fiscal years 2002 through 2005 and 2007 through 2008, during which time the impact on the indirect cost pool ranged from a net annual understatement of \$6,282 to a net annual overstatement of \$114,619.

<sup>14</sup> The Commission has used the 2 percent administrative assessment from at least 1993 through the present.

<sup>15</sup> OMB Circular A-87, attachments E at F.2. and C at G.4.

In fiscal year 2006, the Commission eliminated direct project and select indirect activity assessments for data processing and instead charged all actual data processing expenses, totaling \$357,806, to the indirect cost pool. Not only was this a departure from the Commission's past practices, it also perpetuated the problem of distributing data processing costs uniformly, but inequitably, to all direct projects via the indirect cost rate. Because neither method met the minimum standards for either support or consistent treatment of costs, we questioned the total of data processing costs claimed.

In cases such as the fisheries disaster awards and the State of California-sponsored projects, where the Commission contends that the funding agencies imposed limits on the amount or method of collection of administrative or management costs allowed, cost principles prohibit shifting amounts allocable to, but not recoverable under, one award to another.<sup>16</sup> Because the Commission did not account for the costs it incurred to administer these projects as direct costs, but rather absorbed the costs in the indirect cost pool, there is no assurance that the fees it billed matched those it incurred, or that under-recoveries were not improperly shifted to other direct projects through the Commission's indirect cost rate.

***B. The Commission Had Not Developed Adequate Indirect Cost Methodology, Policies, Procedures, and Controls***

Coupled with an accurate, adequate, and properly implemented cost accounting system, an indirect cost methodology would have provided a platform for developing, documenting, and certifying the Commission's annual indirect cost rate proposals. An indirect cost methodology sets forth indirect cost recovery goals; documents the recovery method to be used; establishes the costing policy; details the components of the indirect cost pool(s); identifies the direct cost allocation base(s); establishes policies, procedures, and controls for developing, supporting, certifying, submitting, using, and adjusting the rate(s); and delineates authorities and responsibilities.

During the period audited, the Commission had not established an indirect cost methodology to focus preparation of its indirect cost plan, promote consistency from year to year, exclude unallowable costs, ensure that its indirect cost proposals produced an equitable distribution of allowable indirect costs to projects in proportion to the relative benefits received, and consistently guide its rate proposal and adjustment process.<sup>17</sup>

***C. The Commission's Indirect Cost Method Failed to Equitably Distribute Indirect Costs***

Indirect cost distribution can take several forms but must result in an equitable distribution of indirect costs to direct projects in proportion to the relative benefits derived.<sup>18</sup> Where a recipient's indirect costs benefit its major functions in varying degrees, equity and federal cost principles require that the costs be accumulated in separate groupings, each of which is allocated

<sup>16</sup> OMB Circular A-87, attachment A at C.3.c. and F.3.

<sup>17</sup> OMB Circular A-87, attachment A at C.1.e. and f., C.3.d., D.2., F.1; attachment E at B.1. and 2., D.1.a. and D.2.a. through d.

<sup>18</sup> OMB Circular A-87, attachment E at C.2.c.



individually to benefiting activities by means of a base or bases that best measure the relative benefits.<sup>19</sup>

Lacking an indirect cost methodology tailored to its specific circumstances, the Commission elected to recover indirect costs using the simplified indirect allocation method, and distributed a single indirect cost pool to projects on a single modified total direct cost base. This cost base excludes extraordinary or distorting expenditures such as capital expenditures, subawards, contracts, assistance payments, and pass-through funds and in the proper circumstances can be an acceptable distribution base.

By employing a simplified method, the Commission in effect asserted that its major functions benefited from indirect costs to approximately the same degree because that is the only case in which this method is appropriate. However, as noted in previous sections of this report, in addition to including misclassified, unallowable, unsupported, and duplicative costs in its single indirect cost pool, the Commission also (1) included several items in the pool that benefited some—but not all—projects and programs included in the total modified direct cost base (page 8), (2) excluded some projects and activities from the base that should have absorbed a fair share of indirect costs (page 6), and (3) improperly shifted labor and fringe benefits in the base from one direct project to another (page 7). Therefore, even if all the other deficiencies presented in this report were corrected, the Commission’s application of the indirect cost rates produced using the simplified method would still fail to achieve the equitable distribution of indirect costs required by federal cost principles and Commerce policy.

#### ***D. The Commission Did Not Adjust Fixed Indirect Cost Rates to Reflect Actual Costs***

The Commission did not employ the carry-forward provision required to adjust its fixed indirect cost rate to the actual, allowable indirect costs incurred. The carry-forward provision provides for identifying the difference between estimated indirect costs and the actual, allowable indirect costs for an entity’s fiscal year and carrying the difference forward as an adjustment to the fixed rate computation for the subsequent fiscal year. As shown in table 1, the Commission made no adjustment to its fixed indirect cost rates for fiscal years 2002 through 2005 and 2007 through 2008.<sup>20</sup>

***Table 1. Indirect Cost Rates Proposed and Accepted by Audit***

Fiscal Year	Attached to or Proposed in Award Applications	Indirect Cost Rate Claimed by the Commission	Actual Indirect Cost Rate Proposed by the Commission in January 2009	Revised Actual Indirect Cost Rate Proposed by the Commission in March 2009	Accepted by Audit
Rates as a Percent of Total Modified Direct Costs					
2002	15.1	15	16.09	15.74	NONE
2003	15	15	12.26	12.28	NONE
2004	15	15	13.32	11.47	NONE

<sup>19</sup> OMB Circular A-87, attachment E at C.3. and 4.

<sup>20</sup> The Commission applied a 15 percent indirect cost rate to total modified direct cost each year since at least 1993 through 2006, when in mid-year it retroactively adjusted its claimed rate to 13 percent.

**Table 1. Indirect Cost Rates Proposed and Accepted by Audit**

Fiscal Year	Attached to or Proposed in Award Applications	Indirect Cost Rate Claimed by the Commission	Actual Indirect Cost Rate Proposed by the Commission in January 2009	Revised Actual Indirect Cost Rate Proposed by the Commission in March 2009	Accepted by Audit
Rates as a Percent of Total Modified Direct Costs					
2005	15	15	12	11.77	NONE
2006	15	15 revised to 13 as of July 1, 2005	15.03	16.25	NONE
2007	13	13	13	13.25	NONE
2008	13	13	Version 1—14.47 Version 2—11.72	15.81	NONE
Source: Commission					

The Commission did not use the roll-forward adjustment provision in fiscal year 2006 either. Rather, in mid-fiscal year 2006, the Commission introduced a different, unacceptable practice by retroactively adjusting the indirect cost rate it initially applied in 2006 to an unsupported rate of 13 percent.

### III. Conclusion

As described in the first finding of this report, the Commission failed to properly prepare, support, and certify its indirect cost rate proposals for fiscal years 2002 through 2008. The Commission incurred indirect cost during the period under audit; however, until it brings its indirect cost proposals and rates into compliance with federal requirements, none of its indirect cost rates, claims, and administrative assessments for the audit period 2002 to 2008 are allowable for federal participation.

The deficiencies described in finding I alone would result in disallowance of any indirect cost claim. However, as described in finding II, we also tested and found significant deficiencies in the cost accounting system; indirect cost methodology; policies, procedures, and controls; and cost distribution system. These deficiencies would also have to be corrected for indirect cost claims to be allowable.

We found significant deficiencies in every area of indirect cost we tested. The Commission's indirect cost claims did not meet the requirements of OMB Circular A-87. Consequently, none of the \$15.6 million the Commission recovered during that period is allowable for federal participation.<sup>21</sup> In addition, the NOAA Grants Officer should disallow any indirect cost claims subsequent to the audit period for which the Commission has not corrected the deficiencies we describe here. Finally, no administrative assessments or direct charges for data processing fees should be allowed on on-going or future awards. See the following section, "Subsequent Events," for a discussion of events that occurred after the audit period.

<sup>21</sup> OMB Circular A-87, attachment A at C.3.d. and H; attachment E at D.

#### IV. Subsequent Events

For its fiscal year ending June 30, 2009, the Commission used a proposed indirect cost rate of 13 percent, applied to modified total direct costs, to recover indirect cost of \$1,151,951 from Commerce and \$997,155 from other federal sources. It also used a rate of 2 percent, applied to pass-through funds and select projects, to collect administrative fees of \$3,497,837 from Commerce and \$108,178 from other federal sources.<sup>22</sup> The Commission based its 2009 proposed indirect cost rate on an unacceptable computation for 2008. No support was provided for the administrative fee.

As detailed in this report, we do not accept the Commission's indirect cost rates or administrative fees for fiscal years 2002 through 2008; therefore, the NOAA Grants Officer should not accept indirect cost claims subsequent to 2008 until the Commission corrects the deficiencies described in this report.

#### V. Recommendations

We recommend the NOAA Grants Officer

1. Require the Commission to comply with minimum federal financial management standards, to include the following:
  - a. Improving its project cost accounting system and related controls to ensure that all direct projects are identified and assigned a project number, that related expenses and revenues are tracked, and that each project receives a fair share of indirect costs in proportion to the benefits received.
  - b. Developing and documenting an indirect cost methodology to include the rationale for the rate(s), including underlying pool(s) and base(s) selected, a cost classification policy, and a process for identifying and excluding unallowable costs. This should include documenting whether the indirect cost base(s) selected provides for equitable distribution of indirect costs to projects in proportion to the benefits received and whether a single or multiple indirect cost pools better allocate costs to projects.
  - c. Establishing the processes, procedures, and controls to develop, support, submit, and subsequently adjust indirect cost rate proposals to actual cost incurred, and identifying the related responsibilities and authorities.
  - d. Documenting the Commission's indirect cost rate proposals and certifications and submitting data in accordance with federal cost principles, the terms and conditions of the award, and specific directions of the Grants Officer.
2. Establish a deadline for the Commission to develop and submit revised indirect cost plans and certifications in accordance with federal cost principles and department policies for negotiation of actual indirect cost rates. Recover indirect costs claimed in excess of the

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<sup>22</sup> The Commission provided the amount of indirect cost and administrative fees recovered in fiscal 2009.

negotiated rates; or, if the Commission declines to revise or certify its plans or fails to meet the established deadline, recover all Commission indirect cost claims for the period 2002 to the present as provided by OMB Circular A-87, attachment A at H.1. and 2, and attachment E at E.4. In the event prior indirect cost claims are recovered, the amount of recovery will be \$8,742,475 (\$8,532,322 from page 1, plus \$1,151,951 from page 11 less \$941,798 to be recovered under the related OIG audit report on the Commission's cooperative agreements).

3. Suspend payment of indirect costs under all current awards and prohibit recovery for future awards until the Commission develops and negotiates acceptable indirect cost rates.
4. Advise the Commission that its unsupported 2 percent administrative and direct data processing assessments are unallowable for federal participation on all current and future awards. Require the Commission to identify and remit all administrative and direct data processing assessments claimed for the period 2002 to the present. The amount of recovery for administrative fees will be \$5,316,759 (\$2,116,782 from page 1, plus \$3,497,837 from page 11 less \$297,860 to be recovered under the related OIG audit report on the Commission's cooperative agreements.
5. Advise the Department's Indirect Cost Program Coordinator in the Office of Acquisition Management of the results of this audit and our recommendations. As the Commission receives both financial assistance and acquisition funding from multiple federal sources, the Department, in its cognizant agency role, should then immediately notify all of its bureaus as well as other federal agencies that have provided federal financial and acquisition assistance to the Commission from 2002 through the present. The Grants Officer should then obtain and provide evidence to OIG that the bureaus and other federal agencies have been notified.

## **Appendix A: Objectives, Scope, and Methodology**

The objectives of this indirect cost audit were to determine whether the rate computations for indirect cost and administrative assessments (1) were supported by and consistent with certified indirect cost proposals and established rate negotiations; (2) produced an equitable allocation of indirect costs to Commission projects and activities; (3) were allowable in accordance with the requirements of the Office of Management and Budget (OMB) Circular A-87; (4) were appropriately and consistently applied; and (5) were accurately adjusted using roll-forward provisions.

- and technical files provided by the National Oceanic and Atmospheric Administration (NOAA);
- examination of financial, personnel, and performance records;
- interviews with NOAA and Commission staff;
- application of relevant analytical procedures using a risk-based approach to select areas for audit, and nonprobability sampling to identify select elements within those areas for detailed transaction testing; and
- review of OMB Circular A-133 single audit reports and related work papers and management letters issued by the Commission's external auditor for the fiscal years ending June 30, 2002, through June 30, 2008.

We conducted fieldwork in the Commission's Portland, Oregon, office during the periods of January 20 to February 4 and March 30 to April 17, 2009; at the Commission's independent audit firm in Lake Oswego, Oregon; and at the offices of three of the Commission's contractors in Salem, Oregon, and Olympia and Seattle, Washington.

The audit included an evaluation of the Commission's internal controls and its compliance with laws and regulations as they related to financial assistance award provisions, specifically those provisions pertaining to financial management and reporting. Key criteria we considered in conducting the audit included the Commission's applications and application assurances; the NOAA awards and their respective standard and special terms and conditions; *Department of Commerce Financial Assistance Standard Terms and Conditions*; OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*; and 15 CFR Part 24, *Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments*. Our review disclosed that the Commission did not adhere to applicable award requirements as detailed in this report.

The Commission used computer-based accounting systems to track and report the financial results of the project. To address the objectives of this audit, we obtained the Commission's payroll information in electronic format for the period July 1, 2001, through December 31, 2008. As a result of an accounting system conversion, general ledger and accounts payable information



were received electronically for the period of March 15, 2002, through mid-January 2009. For the initial portion of the Commission's fiscal year 2002 excluded from the electronic submission, the Commission provided system summary reports. To assess the reliability of the electronic revenue and expenditure data, we

- looked for obvious errors in accuracy and completeness;
- interviewed Commission employees that were knowledgeable about the data;
- worked closely with Commission employees to identify any data problems;
- agreed general ledger totals from the electronic files to the audited financial statements;
- traced financial claims and contract invoices to the automated accounting systems and to source documents; and
- for costs in the indirect cost pool, traced selected accounts payable documents to the general ledger.

We did not rely solely on the computer-generated data as the basis for our audit conclusions. We traced indirect cost proposals to the Commission's automated accounting systems and to source documents.

The audit was performed under the authority of the Inspector General Act of 1978, as amended, and Department Organization Order 10-13, dated August 31, 2006. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## **Appendix B: Detail of Indirect Cost Audit**

While the Commission incurred indirect costs during the period under audit, we could not determine the actual amount of allowable indirect costs. Our testing was risk-based but did not use statistical sampling, and we could not project the results of our testing to the universe of indirect costs to derive audit-accepted indirect cost rates. The inability to project the results of our testing of component cost does not affect our conclusions about the lack of acceptability of the Commission's indirect cost rates.

The Commission was deficient in every area that we tested. It did not submit indirect cost proposals, nor did it submit the certifications necessary to appropriately claim indirect costs. In addition, the deficiencies presented in this appendix also result in unallowable indirect cost claims. Our indirect cost findings starting on page 3 of this report detail a significant number of deficiencies contributing to our inability to accept the Commission's indirect cost rates for 2002 through 2008; however, they do not detail the reasons for our conclusion that recalculated indirect cost rates continued to include unallowable costs, unsupported costs, inconsistently treated expenses, and direct costs treated as indirect. A discussion of our specific concerns regarding the component cost aspect of the Commission's indirect cost rates follows.

### ***A. The Commission Treated Bonuses Inconsistently***

Federal cost principles state that, to be allowable to a federal award, costs must be accorded consistent treatment.<sup>23</sup> A cost may not be assigned as a direct cost to a federal award if any other cost incurred for a similar purpose in like circumstances has been allocated to the federal award as an indirect cost.

The Commission did not treat individual costs consistently. Our review of costs charged to the indirect cost pool identified three bonus payments totaling \$24,481 that were inconsistently charged to the indirect cost pool. Salary costs for the employees associated with these bonus payments were generally charged directly to federal programs. For example, during fiscal year 2008 the Commission charged 85 percent of the bonus costs paid to one employee to the indirect cost pool and the remaining 15 percent directly to the federal program. However, other employees whose regular salaries were charged directly to programs received bonus payments that were also charged directly to the federal program. The Commission's failure to develop an adequate costing policy resulted in an inconsistent treatment of costs.

### ***B. The Commission Charged Unallowable Costs to the Indirect Cost Pool***

Our review of costs charged to the indirect cost pool for fiscal years 2002 through 2008 revealed the following instances of non-compliance with federal cost principles:

1. *Necessary and Reasonable Costs* - Federal cost principles require that costs charged either directly or indirectly to federal programs be necessary and reasonable for proper

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<sup>23</sup> OMB Circular A-87, attachment A at C.1.f.

and efficient performance and administration of federal awards.<sup>24</sup> A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost.<sup>25</sup> Although the determination of “reasonableness” may be somewhat subjective, a determination of reasonableness shall consider whether the cost is, in part, generally recognized as ordinary and necessary for the operation of the governmental unit or the performance of the federal award and the market prices for comparable goods or services.<sup>26</sup>

Our review of travel expenditures paid during fiscal years 2002 through 2008 revealed the Commission leased a vehicle for the exclusive use of a senior official at a cost of approximately \$75,689, including monthly lease payments, insurance, repairs, and maintenance. Commission management stated that no cost-benefit analysis of the lease options was conducted. We requested mileage logs supporting the personal mileage charged as a taxable fringe benefit to the official, which should have been excluded from the Commission’s indirect cost pool. The official reported that he kept a log during the year, but did not retain the logs.

2. *Direct Cost Charged to Indirect Cost* - Federal cost principles provide that costs are allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with the relative benefits received.<sup>27</sup> Costs charged to the Commission’s indirect cost pool should be costs that, although not directly benefitting a specific project or activity, provide a benefit to all projects and activities and should, therefore, be charged using the indirect cost rate. Costs that are specific to a federal program or other direct-funded project are not allocable to the indirect cost pool because these costs do not benefit all direct-funded programs. The Commission is charging direct-funded program costs to the indirect cost pool. For example, the Commission paid a software developer \$40,000 for software required to administer the pikeminnow program, a Department of Energy direct-funded activity that was inappropriately charged to the indirect cost pool and allocated to other direct projects.

We also identified instances in which the Commission’s front office staff was paid to plan and coordinate conferences for other federal and state agencies. For instance, the front office staff planned and coordinated a conference for the National Oceanic and Atmospheric Administration (NOAA). Although NOAA paid the Commission for its services, we identified travel costs associated with planning the conference that were charged to the indirect cost pool and, therefore, charged to direct-funded programs through application of the indirect cost rate. We were unable to determine the exact costs charged to the indirect cost pool for these activities because the costs are not associated with a direct-funded project code in the general ledger.

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<sup>24</sup> OMB Circular A-87, attachment A at C.1.a.

<sup>25</sup> OMB Circular A-87, attachment A at C.2.

<sup>26</sup> OMB Circular A-87, attachment A at C.2.a. and c.

<sup>27</sup> OMB Circular A-87, attachment A at C.1.b. and C.3.

3. *Inadequate Documentation of Costs* - Federal cost principles and uniform administrative requirements state that costs must be adequately documented.<sup>28</sup> Our tests of costs charged to the indirect cost pool revealed costs totaling \$38,121 were not adequately supported. Receipts were either missing or failed to include sufficient detail to determine the allowability of the charges.
4. *Undocumented and Excessive Travel Costs* - The Commission established a written travel policy based on federal travel regulations. Our tests of travel costs charged to the indirect cost pool identified costs totaling \$24,221 that either did not comply with the travel policy or did not contain sufficient information with which to determine compliance. In addition, the Commission's travel policy required all travelers to submit travel claims for reimbursement that document the purpose of the travel, the per diem reimbursement for the destination, and other incidental costs paid during the trip. We noted that a senior official did not submit the required travel claim forms, and several reimbursements exceeded the per diem amount for the location of the travel.
5. *Entertainment Costs* - Federal cost principles state that the cost of entertainment, including amusements, diversions, and social activities and any directly associated costs (such as tickets to shows or sport events, meals, lodging, rentals, transportation and gratuities), are unallowable.<sup>29</sup> Our tests of expenditures charged to the indirect cost pool during fiscal years 2002 through 2008 identified a total of \$40,790 in what appear to be entertainment costs. For example, Commission staff calculated that the Commission paid \$30,722 for its annual holiday parties between 2002 and 2008. Our audit identified additional costs associated with holiday parties that were not included on the Commission's list, leading us to believe that the actual entertainment costs paid by the Commission are likely higher than amounts identified by either the Commission or by our review.
6. *Capital Expenditures Charged to Expenses* - Federal cost principles and uniform administrative requirements define equipment as non-expendable tangible personal property having a useful life exceeding one year and an acquisition cost that equals the lesser of \$5,000 or the governmental unit's own capitalization threshold.<sup>30</sup> The Commission's capitalization policy states that "capital expenditures are any purchase of equipment of property costing more than \$1,000 and with a life expectancy of more than one year."

The indirect cost rate proposals the Commission initially provided us in January 2009 improperly included in the indirect cost pool a significant number of equipment purchases that met the Commission's \$1,000 capitalization threshold. For this and other reasons, we requested Commission management to prepare corrected proposals, which were provided to us in March 2009. According to Commission management, capital costs had been removed from the indirect cost pool. However, tests of the revised indirect cost

<sup>28</sup> OMB Circular A-87, attachment A at C.1.j., and 15 CFR § 24.20(b)(2), (5), and (6).

<sup>29</sup> OMB Circular A-87 (1995) at attachment B.18 and OMB Circular A-87 (2004) at attachment B.14.

<sup>30</sup> OMB Circular A-87 (1995) at attachment B.19.a.(2); OMB Circular A-87 (2004) at attachment B.15.a.(2); and uniform administrative requirements, 15 CFR 24.3.

proposals identified costs totaling \$53,872 for items that should have been capitalized. For example, we identified a search engine costing \$27,005 that the Commission accounting staff agreed was an asset that should have been capitalized, but the Commission expensed the cost, charged it to the indirect cost pool, and failed to remove it from the revised indirect cost proposal.

7. *Contributions* - Federal cost principles state that recipient contributions, including cash, property and services, to others are unallowable.<sup>31</sup> Our tests of the Commission's revised indirect cost pools identified transactions totaling \$20,215 for unallowable gifts and donations. For example, we identified a number of payments for such items as gifts, memorials, charitable donations, and a \$1,500 gift given to a retiring NOAA official.
8. *Lobbying Costs* - Federal cost principles provide that the cost of certain influencing activities associated with obtaining grants, contracts, cooperative agreements, or loans is unallowable.<sup>32</sup> During the audit period, the Commission paid a lobbying firm for both lobbying and non-lobbying activities. However, the firm's invoices did not provide sufficient detail to ensure that they did not contain unallowable lobbying costs. Our testing identified invoices totaling \$11,618 that lacked sufficient detail to determine whether the costs were allowable.
9. *Bonus Payments Inadequately Supported* - Federal cost principles require, in part, that salary costs be charged to cost objectives in accordance with the relative benefits received and in accordance with governmental unit's established policy.<sup>33</sup> The Circular further details the minimum documentation required to support allowable labor allocations. Tests of salary costs charged to the indirect cost pool revealed the Commission charged employee bonuses totaling \$311,445 without the support required to demonstrate that payments complied with the Commission's bonus policy. For example, the Commission paid a bonus totaling \$34,276 to a manager in March 2007; however, there was no performance evaluation to support the bonus.
10. *Salary and Bonus Cost Charged to Incorrect Project* - Federal regulations require that employees charging salary costs to multiple cost objectives complete personnel activity reports documenting the actual time and effort worked on each cost objective as the basis for allocating cost to direct projects and indirect activities.<sup>34</sup> As discussed in this report, the Commission had time distribution systems and a project cost accounting system that, if properly implemented, would have adequately accounted for direct and indirect labor and related fringe benefits. However, the systems were not properly implemented and were subject to arbitrary override. As a result, tests of labor and fringe benefits charges
  - Identified seven employees whose salary costs of \$1,812,223 were charged to the indirect cost pool even though at least part of the employees' job responsibilities related to direct-funded projects.

<sup>31</sup> OMB Circular A-87 (1995) at attachment B.13 and OMB Circular A-87 (2004) at B.12.

<sup>32</sup> OMB Circular A-87 (1995) at attachment B.27 and OMB Circular A-87 (2004) at B.24.

<sup>33</sup> OMB Circular A-87 (1995) at attachment B.11 and OMB Circular A-87 (2004) at B.8.

<sup>34</sup> OMB Circular A-87 (1995) at attachment B.11.h. (4) and (5) and OMB Circular A-87 (2004) at B.8.h.(4) and (5).



- Disclosed that a number of Commission employees received bonuses in fiscal year 2008 due to their work on the Salmon Disaster Program. Because this program is a direct-funded activity, it should be established as a direct program in the Commission's project cost accounting system and general ledger, and indirect costs should be allocated to the program as done with other federally funded projects. However, the Commission treated the Salmon Disaster Program as an indirect activity and charged all associated costs, including labor and benefits, to the indirect cost pool. In the absence of personnel activity reports, we were unable to quantify mischarged costs related to this project.
- Revealed instances in which three staff members and a senior official performed direct-funded activities; however, their salary costs were charged to the indirect cost pool. We were unable to quantify the salary costs attributable to the direct funded activities because the costs were not separately identified in the general ledger or supported by the requisite personnel activity reports.

**Appendix C: Commission Response**  
**(Cover Letter Only)**



PACIFIC STATES MARINE FISHERIES COMMISSION  
205 S.E. SPOKANE STREET, SUITE 100 • PORTLAND, OREGON 97202-6487  
PHONE: (503) 595-3100 • FAX: (503) 595-3232  
[www.psmfc.org](http://www.psmfc.org)

March 18, 2011

Mr. Jerry McMahan  
Assistant Regional Inspector General for Audits  
U.S. Department of Commerce  
401 West Peachtree Street NW, Suite 2742  
Atlanta, GA 30308

BY EXPRESS DELIVERY: FED EX

Dear Mr. McMahan:

This letter transmits the response of the Pacific States Marine Fisheries Commission to the Draft Report issued by the Department of Commerce Office of Inspector General, dated February 22, 2011 concerning indirect cost plans and rates.

Given the breadth and seriousness of the assertions and recommendations made in the report, the long delay between completion of the field work in April 2009 and the release of the draft report is very troubling to our agency and appears contrary to the supplementary guidance on audit report quality contained in *Governmental Auditing Standards*.

Due to the severity of the findings and recommendations in the draft, we are addressing them in their entirety in the enclosed attachment. Further, under separate cover, we are transmitting copies of the documentation which we believe, throughout the draft report, is incorrectly claimed to have been lacking or inadequate at the time of the audit. Based on the submission of these items, you will note that we have, at various points, requested that the text of the audit report be revised to more accurately reflect the facts surrounding our indirect cost claims. Further, in accordance with Section 8.33 of *Governmental Auditing Standards*, we specifically request that the full text of this letter and the enclosed attachment be included in any final report issued by your office.

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"To promote the conservation, development and management of Pacific coast fishery resources through coordinated regional research, monitoring and utilization"

We believe that the extensive submissions that we are making will help assure that the resulting audit report is more fair, complete, and objective. If there are questions about these documents or further need for clarification or dialogue, please contact me or Pam Kahut, our Chief Financial Officer.

Yours truly,



Randy Fisher  
Executive Director

Attachments:

Response to Draft Audit Report

Supporting Documentation as listed throughout Exhibit B:

1. Letter dated February 25, 1986 from Oral Butcher
2. Letter dated May 8, 2008 from Gary Johnson
3. Letter dated April 22, 1992 to DOC OIG
4. Letter dated September 15, 1992 from DOC
5. Letter dated July 31, 2002 from NOAA Grants Management Division
6. A-133 Annual Audited Financial Statements (2002-2009)
7. Indirect Cost Rates
8. E-mail from Nicolle Hill, Federal Program Officer
9. E-mails from Janet Russell and Rosalie Vega (Grant Specialists)
10. Excerpt from 1985 OMB Cognizance Listing
11. Subsidiary Ledger Worksheets
12. General Ledger Codes from Commission Financial Management System
13. Job List from Commission Financial Management System
14. Commission Revised Travel Policy
15. Capitalization Policy
16. Annual Lease Valuation Report (Sample form)
17. E-mail to OIG Auditors Requesting Data
18. PSMFC Indirect Cost Plan Functional Statement and Organization Chart

Cc: (without attachments)

Barry Berkowitz, Senior Procurement Executive and Director, Office of Acquisition Management  
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Additional copies are being provided to NOAA Offices to which electronic versions of the audit report were provided by the OIG

**Response to Draft Audit Report of the Pacific States Marine Fisheries Commission  
Indirect Cost Plans and Rates**

**Findings and Recommendations:**

The draft report states that the Commission failed to comply with the minimum requirements necessary to recover indirect costs under federal awards. There are no statements contained in the draft audit report concerning the steps that the OIG audit team was expected to take pursuant to Section 215(a) of OMB Circular A-133 to build on indirect cost related work performed by the Commission's independent auditors.

In the absence of the draft audit report, some corrective actions have been taken on a number of matters that were called to the attention of Commission staff during the audit. However, we do not believe it is appropriate to commit to correct conditions that we do not agree are deficient in anything approaching the degree to which the draft audit report asserts that they are. Our organization is committed to proper stewardship of the federal funding we receive and to the accomplishment of the important program objectives that those funds support. The Commission is responding section by section to the draft audit report as outlined below.

The audit report asserts that the Commission's unsubmitted indirect cost proposals and rates were not allowable in accordance with OMB Circular A-87 and asserts, among other things, that one of the reasons for the departure from the Circular's requirements is that "The Commission's accounting system is inadequate." In information which follows, the Commission demonstrates that this blanket statement is incorrect and overreaching. It also submits that the requirements for a cost accounting system do not arise from Circular A-87 but from the Common Rule for Grants Administration issued pursuant to OMB Circular A-102 and implemented at the Department of Commerce in 15 CFR 24.20(b).

**I. The Commission did not submit, certify, or adequately support indirect cost rate proposals**

The draft report states that the Commission retained its indirect cost proposals on file rather than submitting them to the Department of Commerce, despite the NOAA Grants Officer's multiple requests for the proposals. In OMB Circular A-87, Attachment E, Section D.1.b, as a state and local government unit, the Commission is not required to submit cost allocation plans to their cognizant agency unless specifically requested. The Commission must prepare and retain copies.

At various times throughout the years, the Commission received correspondence from our cognizant agency confirming the A-87 requirements. For example, as noted in a February 25, 1986 letter (Attachment 1) from Oral Butcher, Director Audit Operations Staff of the Office of Inspector General Washington DC office, "the information provided, we were considered a local unit of government as defined in Section B.10 of Attachment A to OMB Circular A-87 [This citation is the version of A-87 which was applicable at the time]. And as authorized by Section J.5.a of that Attachment, we were not required to submit cost allocation plans to their office unless specifically requested. However, we must prepare and retain copies at the local government level. Copies of this letter could be provided to anyone inquiring about their policy regarding indirect cost rate proposals for units of local government. This policy remains in effect until further notice." Again in May 2008 in a letter from Gary Johnson,



Acting Director of Grants Management Division, Office of Acquisition Management, US Department of Commerce (Attachment 2) confirmed that no further proposal submission action was currently required under Department of Commerce (DOC) Financial Assistance Standard Terms & Conditions A.05, Indirect Costs. And pursuant to OMB Circular A-87, Cost Principles for State, Local, and Federally-recognized Tribal Governments, our organization is not required to submit an indirect cost allocation proposal or plan narrative to its cognizant agency. The plans are to be prepared and retained at the local government level.

Throughout the early years, the Commission kept the Department of Commerce informed by submitting copies of our A-133 Financial Audits and updated Indirect Cost Rates. In 1990 we requested a change to our indirect cost rate, but did not receive an official response in a timely manner that it had been accepted and approved. The Commission sent a letter dated April 22, 1992 to Department of Commerce Office of Inspector General in Washington DC (Attachment 3) forwarding their Fiscal Year 1991 A-133 Financial audit report and brought to their attention the lack of response for the Fiscal Year 1990 indirect cost rate change request. In September 1992 we received an executed copy of the Indirect Cost Negotiation Agreement for FY 1990 – FY 1992 (Attachment 4). In August 1993 we received an approved rate agreement for fiscal year 1993. In fiscal year 1994 the Commission's agency funding levels shifted and Department of Energy, Bonneville Power Administration became our predominant federal funding source. Because of this shift, we voluntarily contacted Bonneville Power Administration for approval of our indirect cost allocation plan. After two years of discussions between Department Commerce and Bonneville Power Administration, an in-depth review by Bonneville auditors of our accounting methodology occurred. After this review, we received an approved indirect cost negotiation agreement from Bonneville Power Administration for the period July 1, 1992 to June 30, 1997 for a Fixed Carry-forward rate of 15% and a Fixed 2% rate for pass-through funds.

We continued to forward our A-133 Financial audit reports to Bonneville Power Administration and since our methodology and rate had not changed, we were directed that as a local government agency, we were not required to submit our indirect cost rate on an annual basis, just to retain on file the indirect cost rate and supporting documentation.

In January 2002 we were selected for an audit by the Department of Commerce Inspector General. The Seattle office sent staff to our office to conduct the audit. During the audit, the DOC Inspector General Staff member discussed with Bonneville Power Administration the Commission's indirect cost rate and proceeded to confirm the direction we had received from Bonneville Power Administration that we were not required to submit an indirect cost allocation plan to our cognizant agency, but to retain on file. At no time were we notified by the Department of Commerce Office of Acquisition Management that the Commission was required to submit a copy of our indirect cost allocation plan for review and approval. In addition, at no time during 2002 to 2008 have we been notified from the Department of Commerce that they are our cognizant agency for indirect cost negotiation.

A request from the NOAA Grants Officer for information on the Commission's indirect cost rate was in a letter to the Commission dated July 31 2002 (Attachment 5) referenced to NOAA Award NA17FN2536 as:

"Regarding your request for indirect costs, since your indirect cost rate expired before the award date, please refer to US Department of Commerce Financial Assistance Standard Terms and Conditions of A.05, which outlines steps you must take to apply for an indirect cost rate and to recover indirect costs from this award."

The Commission has not received an "Agreement" from a cognizant agency since 1996; therefore the reference to an "expiration" of our indirect cost rate is irrelevant. The Grants Office would inquire about an "Indirect Cost Rate Agreement", and Commission staff would send the only "Agreement" we had on record which was the one prepared by Bonneville Power Administration in 1994. However, the Commission always had on file the recent indirect cost rate calculation based on the annual audited financial statements.

The Commission's indirect cost rate is calculated on an annual basis as part of our A-133 annual financial audit (Attachment 6-copies of A-133 Audited Financial Statements). Based on the financial information from this audit, an indirect cost rate is calculated based on data from the financial audit (see copies of annual indirect cost rates attached-Attachment 7). Commission staff always attends the NOAA Grant Workshops that are held on the West Coast for grant recipients. For many years, the topic of indirect cost allocation plans and the lack of response from the Department of Commerce with regards to acceptance were discussed. We were continually advised that due to the backlog of requests, recipients should keep copies on file, as stated in OMB Circular A-87, until the Department of Commerce released clear guidance. It was not until April 2008 that we were notified by our NOAA Federal Program Officer that this updated, revised guidance had been released (Attachment 8). The Commission immediately submitted the Certificate to the Department of Commerce Office of Acquisition Management and we requested, in writing, their acceptance of our Certificate (dated May 8, 2008, Attachment 2).

As part of the NOAA Grant process, we attach a copy of our most current indirect cost rate information to the proposal and on numerous occasions, when requested from the NOAA Grants Office, we forwarded additional copies (e-mail request from Janet Russell, July 24, 2006; e-mail request from Rosalie Vega, August 18, 2006 (Attachment 9)).

It is noted on page 3 of the draft report that departmental policy limits indirect cost recovery to the lesser of (1) the amount authorized in the approved award budget, or (2) the federal share of the total indirect cost allocable to the award computed using the indirect cost rate approved by a cognizant or oversight federal agency and current at the time the cost was incurred (provided that the rate used was approved on or before the award end date). Footnote 5-references the Financial Assistance Standard Terms and Conditions attached to awards. The Financial Assistance Standard Terms and Conditions states in Section A.05:

- (a) Indirect cost will not be allowable charges against the award unless specifically included as a cost item in the approved budget incorporated into the award.

**PSMFC indirect costs were included in the approved budget incorporated into the awards and included on SF424A-Budget Information.**

- (c) If recipient has not previously established an indirect cost rate with a Federal agency, the negotiation and approval of a rate is subject to the procedures in the applicable cost principles and the following subparagraphs.

**PSMFC had established an indirect cost rate with a Federal agency (DOC in 1986 and DOE in 1994).**



Also noted in footnote 5, in December 2007 and April 2008 Commerce issued an updated and expanded indirect cost policy specifically requiring annual submission of indirect cost certificates.

As stated above, in April 2008 the Commission received an e-mail from our NMFS Federal Program office notifying us that DOC had just published a new document with procedures for indirect cost rates (Attachment 8). On May 1, 2008 the Commission submitted to DOC Office of Acquisition Management our Certification of Indirect Cost and requested a signed letter of their acceptance for our files. We received a telephone call from the DOC Office of Acquisition Management clarifying that we did not need a letter for our files, but we explained that due to prior issues with DOC auditors and grant officials, we wanted documentation in our file stating that our request had been received and accepted. As a follow up to our request, we also forwarded a Certificate for our Administrative Fee of 2% for certification; however, we received a telephone call telling us that we did not need to submit that for their certification.

As is shown in considerable detail above and following, the Commission went to extraordinary lengths over an extended number of years to clarify the fact that it was not required to submit its indirect plans to the Department of Commerce. This effort was undertaken despite clear instructions contained in OMB Circular 87 (Appendix E, Paragraph D.1.b) that those organizations not specifically and formally assigned a cognizant agency by the Office of Management and Budget need not submit their plans but are to retain them and the supporting documentation for audit and reinforcement of that policy in section 3B of the annual *Compliance Supplement for Circular A-133 Audits* issued by OMB, which discusses the independent auditor's responsibility for review of indirect costs when no submission to a federal agency is required. Attached is an excerpt from the last formal issuance of indirect cost cognizance assignments issued by the Office of Management and Budget which shows that the Commission was not among those entities located in Oregon which received specific assignments (Attachment 10).

#### **A. The Commission did not Submit Indirect Cost Proposals to the Department**

The draft report states that, in 2003, based on its providing the majority of the Commission's funding, the Department of Commerce assumed cognizance for the Commission. However, there is no indication that this was accomplished through any formal notice to the Commission issued by the Department or any other party.

The report states that the "Grants Officer" repeatedly noted that the Commission's negotiated rate had expired and directed the Commission to comply with the Department of Commerce's financial assistance standard terms and conditions regarding indirect costs. However, the audit report contains no evidence as to when or how these directions were transmitted. Given the previously identified extraordinary lengths to which Commission staff went to assure that they were in compliance with the applicable requirements of OMB Circular A-87, this assertion is particularly problematic. The Commission requests that it be removed from the report.

The Audit Report confirms on page 4, paragraph 2 that federal cost principles "do not require governmental entities such as the Commission to submit indirect cost proposals unless requested by their Cognizant agency." There was no request by the Department of Commerce Acquisition Management office that the Commission was to submit an indirect cost allocation plan for approval. The audit report also stated that Department conditions specifically required the Commission to submit

the "documentation (indirect cost proposals, cost allocation plan, etc.)" necessary to evaluate the indirect cost methodology or negotiate a fixed indirect cost rate and directed that a copy of the letter transmitting the submission also be sent to the NOAA Grants Officer. (references DOC Financial Assistance Standard Terms and Conditions).

The Financial Assistance Standard Terms and Conditions states in Section A.05:

- (b) Indirect cost will not be allowable charges against the award unless specifically included as a cost item in the approved budget incorporated into the award.

**PSMFC indirect costs were included in the approved budget incorporated into the awards and included on SF424A-Budget Information.**

- (d) If recipient has not previously established an indirect cost rate with a Federal agency, the negotiation and approval of a rate is subject to the procedures in the applicable cost principles and the following subparagraphs.

PSMFC had established an indirect cost rate with a Federal agency (DOC in 1986 and BPA in 1994). The Commission had previously established an indirect cost proposal, cost allocation plan, and it had been reviewed by a "Federal agency" in 1986 and 1994. The methodology had been accepted, and to this date, we have not changed our methodology, and a negotiated rate was approved. In subsequent years, the methodology has not changed, and the information was kept on file as instructed by the federal agencies and stated in OMB Circular A-87.

#### **B. The Commission did not Certify Indirect Cost Proposals**

In addition to setting forth the specific documentation required to support indirect cost rate proposals, the draft report states that federal cost principles:

- require state and local recipients to prepare and sign indirect cost certificates to accompany the proposals; and
- permit the Department to disallow all indirect cost when the recipient has not submitted a certified proposal in accordance with requirements.

OMB Circular A-87 does not require the Commission to submit indirect cost rate proposals as a state and local government unit. The circular also addresses certification but does not require submission of the certification unless the entire plan and backup documentation must be submitted. If an agency is not required to submit an indirect cost rate plan, how can there be the power to disallow.

When the Commission has submitted the final financial reports (SF 269; and recently SF 425) to NOAA Grant Office, the Commission is required to identify the type of rate, rate percent, base amount the rate applied to, and the amount of indirect cost charged, and the federal share of that indirect cost charged. These Final Financial Reports have been accepted and approved by the NOAA Grants Office during the close-out process with no question of disallowing any portion of all of the indirect cost charges identified in these reports.

To the extent that the Department of Commerce Standard Terms and Conditions require governmental recipients who are not specifically assigned a cognizant agency to submit, the provisions are contrary to Circular A-87 at 2 CFR 225.30. It is not appropriate or necessary to obtain an exception to the terms and conditions when Circular A-87 already creates a very large one at Appendix E, Paragraph D.1.b.

**C. The Commission did not retain Required Documentation in Support of Its Indirect Cost Plans**

The assertions that the Commission lacked the types of documentation listed in Section C of the report and required under Circular A-87, Appendix E, Paragraph D.2 are completely incorrect as is being demonstrated by the submissions accompanying this response. The submissions were clearly not created during the hiatus between the completion of field work and issuance of the draft report and were fully made available to the auditors during their field work. In addition, the audited financial statements referred to in the second bullet were annually submitted to the Department of Commerce's Federal Audit Clearinghouse in accordance with instructions contained in OMB Circular A-133. The related documentation includes:

- Subsidiary worksheets that are reconciled to supporting financial data
- Copies of comprehensive annual financial reports, executive budgets upon which the data is based;
- Approximate amount of direct base costs incurred under federal awards, broken out between salaries, wages, and other direct costs;
- Organization charts
- Functional statements describing duties and responsibilities of Commission units

The items identified above were available for the auditors review. The Commission's files consist of electronic and paper files. The Commission's indirect cost rate is calculated on an annual basis as part of our annual A-133 financial audit (Attachment 6-copies of A-133 audited financial statements). Journal entries resulting from the audit are recorded in the Commission accounting system and the general ledger balances are tied to the audited financials prior to extracting information for preparation of the Indirect Cost Plan. An indirect cost rate is calculated based on data from the financial audit (see copies of annual indirect cost rate plans attached – Attachment 7). The subsidiary worksheets are reconciled to support the financial data presented in the A-133 Financial Audits (Attachment 11). These worksheets identify the approximate amount of direct base costs incurred under federal awards, broken down by the line item categories of salaries and wages, benefits, and other direct costs as defined in OMB Circular A-87. (See Commission general ledger accounts attached-Attachment 12)

**II. The Commission's Unsubmitted Indirect Cost Proposals were Inadequate, and Rates and Claims were Unallowable**

As emphasized in multiple places above, the Commission is not required under OMB Circular A-87 to submit indirect cost proposals. The rates claimed were allowed by the Department of Commerce Grants Office upon acceptance of the Commission's Final Financial Reports (SF-269 and SF-425) upon closeout of NOAA Awards.



**A. The Commission's Cost Accounting System was Inadequate**

It is stated in the draft report (page 6) that while the Commission's accounting system appeared to offer the necessary cost accounting framework, its underlying costing policy, which defined projects and costs as direct or indirect and provided for identification and segregation of allowable and unallowable costs, was not clearly drawn or consistently implemented. In addition key controls over the cost accounting system were either unavailable or overridden.

The Commission's financial management system has the necessary cost accounting framework for defining projects as direct or indirect. The Commission's issues a job number to each project that we administer (see attached list of Commission Job Numbers assigned to each specific project-Attachment 13). When that job number is assigned, it is assigned in the cost accounting system as an indirect or direct project. A specific job (100U and 100R) is set up for unallowable costs (per A-87) and these costs are not included in either direct or indirect allocations. In discussions with the Inspector General staff, it was apparent that it would be more understandable to an outside party if we had specific general ledger cost codes as defined in A-87 for unallowable costs (contributions, alcohol, fines, etc) so we have established new general ledger codes for these type of expenses (see Attachment 12). It was also apparent during this audit, that all jobs associated with indirect should be in their own series of numbers (200's), so we will be changing the one job assigned to a project within that series to a new job number when the contract comes up for renewal, therefore it will be clean break for indirect and direct job numbers.

On occasion, costs need to be shifted from one job number to another, either due to overlapping funding agreements where the work is related or due to an error by a program manager in assigning a job number to invoices or staff. There is nothing improper about shifting costs as long as documentation is on file supporting the adjustment and the shift is not to overcome funding deficiencies in a particular award. This type of adjustment occurs within every agency.

**Direct Projects were misidentified as Indirect Activities:** Over the past few years, the Commission has been requested to assist NOAA with a number of activities that will benefit the fishery agencies and managers. These activities have included meeting facilitation, administering fishery disaster programs, providing administrative support to Regional Fishery Management Council. In providing assistance, we often use existing administrative support staff to accomplish these tasks which at times are over a very limited time period.

For example, we have been asked to assist with meeting preparation which includes securing meeting sites, logistics, and staff at the meeting to ensure that all aspects during the meeting occur without interruption to meeting participants. When we were first engaged to perform these activities, staff time was not directly identified to the project, which can encompass a week or two of staff time. As the level of NOAA requested assistance has increased, we have worked with the funding agency to provide ample financial support so that the Commission can direct cost their administrative support staff during these activities to the project.

#### Fishery Disaster Programs

When the Commission was approached in 2006 to manage the first Fishery Disaster program, there had been significant delays with the overall declaration of the disaster, appropriation of fund from Congress, and securing a mechanism for disbursing these funds to the eligible fishermen. To ensure that the maximum amount of funds were given to the impacted fishermen and businesses, and since the Commission had only an approved indirect cost rate of 13% or a 2% pass-thru rate, it was agreed by all parties, that the Commission would not direct cost staff or charge the 13% indirect cost rate, but would charge the 2% pass-thru rate on this NOAA Award. Any staff time or other direct expenses (postage, copying, etc.) would be funded with the 2% pass-through rate. A separate job number was assigned for these expenses (215DR) and these costs were excluded from the Commission's indirect cost rate.

#### Pacific Fishery Management Council Bookkeeping

For a period of time, the Commission provided accounting services to the Pacific Fishery Management Council. Because the Commission financial management system allows for separate companies, we were able to establish a separate company database for the Council financial activities. The services we provided included entering accounts payable, issuing Council checks to vendors and council Members for travel, providing the Council reports of transactions and tracking the various NOAA Awards. Since this service did not require an increase in Commission staff, we entered into a subaward with the Council for a fee of \$2,000 per month. This revenue from the Council then offset the expense of the Commission staff member's time that was charged to the indirect cost activities.

#### Facility Management

When the Commission purchased its facility in December 1992, which comprised of 10,000 square feet, a portion of the space was leased by two outside businesses. These two businesses paid rent to the Commission for the square footage they occupied. There was a minimal amount of staff time required in setting up the lease agreements and maintenance was contracted out.

The administrative support staff time spent on these projects identified above were offset with revenue that was collected for these services, except in the case of the meeting preparation. However, in the past year as we have taken on additional requests from NOAA for this service, we have directed support staff expenses to the specific projects.

**Costs were Improperly Shifted from One Direct Project to Another:** There have been numerous times throughout the past 8 years, where the Commission has received funding from NOAA for projects that are ongoing but funded under two separate NOAA awards with overlapping dates. All employees record their hours worked on an electronic timekeeping system. Each employee has a home department based on their job number assigned to their funding agreement, and some employees will have transfer codes if they are working on more than one project (job number). There are times when an employee will enter their time in the timekeeping system and failed to recognize they have a home department and transfer codes for recording their hours worked. Until reports are generated at the end of the month and distributed to managers, this error is not noticed. When this occurs, the accounting staff is contacted by the manager to adjust (shift) hours and benefits to the correct project.

Because the information the accounting staff handles is often after the fact, and sometimes 3-4 weeks old by the time reports are generated, we realized that managers needed to become more proactive in reviewing information and monitoring their projects expenses. The Commission has released to Program Managers and their Administrative Assistants a "read only" functionality of the accounting data for their specific projects. Also, since we pay our employees two weeks in arrears from the actual hours worked, we have set up a process, whereas when the pay period ends, we post hours into the accounting system as an encumbrance so the managers have an up to the date picture of their costs before we process the actual payroll hours and book them as a payable in the accounting system. This process has helped limit the number of shifts (adjustments) the accounting staff is requested to do. If a situation arises where a shift must occur, the employee is required to document the change on their timecard and forward the copy to the Commission staff.

In addition to request for adjustments (shifts) due to incorrect coding by the employee of their hours worked, there are many Commission projects that have overlapping funding sources for the same exact work. Therefore, there will be times (and it is often noted in the grant proposal), where funds from one award will not be expended until funding on previous award is expended for similar work.

These shifts from one direct project to another do not create an inequitable allocation of indirect cost. The Commission responds that such shifting is not prohibited unless it is accomplished to overcome funding deficiencies. Accordingly, when the basis for the transfer is documented, the Commission asserts that propriety can and has been shown.

**Costs were Misclassified, Inconsistently Identified as Direct or Indirect, Unallowable, or Unsupported:**

The Commission's financial management system has the necessary cost accounting framework for defining projects as direct or indirect. The Commission's issues a job number to each project that we administer (see attached list of Commission Job Numbers assigned to each specific project-Attachment 13). When that job number is assigned, it is assigned in the cost accounting system as an indirect or direct project. A specific job (100U) is set up for unallowable costs (per A-87) and these costs are not included in either direct or indirect allocations. In discussions with the Inspector General staff, it was apparent that it would be more understandable to an outsider if we had specific general ledger cost codes as defined in A-87 for unallowable costs (contributions, alcohol, fines, etc) so we have established new general ledger codes for these type of expenses (see Attachment 12). It was also apparent during this audit, that all jobs associated with indirect should be in their own series of numbers (200's), so we will be changing the one job assigned to a project within that series to a new job number when the contract comes up for renewal, therefore it will be clean break for indirect and direct job numbers.

Items addressed in Exhibit B of the draft report that were noted as misclassified, inconsistently identified as direct or indirect, unallowable, or unsupported are explained below under Exhibit B.

**Ancillary Rates and Fees Duplicated or Skewed Indirect Cost Allocations:**

On Page 7 of the Audit Report it states their review disclosed a 2 percent administrative rate that was unsupported and duplicated the Commission's indirect cost recoveries. As noted earlier, the 2% administrative fee assessed on pass-thru funds to our member states was approved in 1994 by the Bonneville Power Administration and the Commission submitted a Certificate in 2008 to Department of Commerce for approval. At the end of the Commission's fiscal year, the amount of revenue generated



with the 2% pass thru administrative fee had an equal amount of indirect cost expenses deducted before the indirect cost rate was calculated (see Subsidiary Ledger-Attachment 11). The expenses deducted are for the accounting and contracting staff to administer the subawards (pass-thru) funds to our member states.

*Administrative Assessments* – When the Commission was approached by NOAA in 2007 to handle the Klamath River Fishery Disaster program, because of the impact of this disaster on the fishery communities, it was important that the maximum amount of funds be distributed to those impacted and the administrative costs for administering this award be minimal. At the time, the Commission could either charge the indirect cost rate of 13% on all direct costs, which out of \$60,000,000 available funds, would be \$6,902,654.86 or 2% \$1,176,470.58. Assessing 2% on this award was a significant savings to the project. Because of the delays in the overall process of legislation establishing the disaster, appropriating funds, and defining eligibility criteria agreed to by all parties (governors of impacted states, federal agencies, and state fishery agencies), it was important not to create any additional delays. The level of administrative work involved with this award was unknown and it was difficult to establish the level of effort. In addition, we were encouraged to keep the Commission's costs minimal. It was apparent that we would need to bring in additional administrative staff to process the level of documentation needed for this project. The cost for this additional administrative support was funded with the 2% administrative fee we incurred on this project (assigned to job number 215DR). The only expenses recorded in the indirect cost pool were for the accounting staff that handled the downloading of data into the financial management system, printing of checks, and tax reporting to the Internal Revenue Service through the Form 1099 process.

In 2009 the Commission was approached again by NOAA to administer the Sacramento River Fishery Disaster Program in the amount of \$170,000,000. Again, in order to keep the administrative support costs to a minimum, we assessed a 2% administrative assessment, which equated to \$3,333,333 instead of 13% or \$19,557,522. The 2% administrative assessment allowed the difference of \$16,224,189 to be applied to the individuals who were impacted by this fishery disaster and not as revenue to the Commission. These two fishery disaster programs were totally unexpected and created a significant spike in the level of funding the Commission administered in a short period of time. There was a huge level of demands, stress and pressure on Commission staff to follow procedures, verifying criteria, and process quickly. Many of those impacted by these disasters were in jeopardy of losing their businesses or homes. To be able to maximize the level of funds distributed for these individuals in a timely manner was rewarding. We were able to provide a valuable service to NOAA and those impacted, but should the Commission continue to administer these types of programs, we will need to revisit the most equitable, allocable process for administrative assessment. These types of programs require a different level of administrative support than our normal pass-thru funds to our member states.

The use of the 2 percent administrative fee in lieu of actual costs incurred was also consistent with the discussion contained in Circular A-87, Appendix A, Paragraph A.2.b, particularly when, as is shown elsewhere in this submission, the fee was backed out of charges that were made for indirect costs. Further, the fee was arrived at because applicable funding agencies improperly and arbitrarily imposed limits on indirect cost recovery.

*Management Fees* – One of the Commission Senior Program Managers oversees the majority of projects funded with the State of California Department of Fish and Game and Water Resources Agencies. In an average year, this can total 50 different projects, which can be cumbersome to direct cost expenses for

his oversight and administrative support team. A process was developed in the early stages whereas the Program Manager was to ensure that an adequate number of hours were budgeted in each project with a loaded rate to include the labor and related expenses to provide oversight to these projects. After a few years it became apparent that this process was not consistent and equitable, therefore, we have recently revisited the process and have defined a process that is consistent, equitable, and is generating sufficient revenue to cover all costs. On a monthly basis, project management oversight costs are applied to all projects where oversight is provided. On an annual basis the amount charged is reconciled with actual costs incurred and any over or under collection is accounted for in the rate calculated for the subsequent year.

*Data Processing Fees* – The Commission's data processing fees were established in 2000 to cover expenses incurred by the Computer Services department which provided support to all Commission staff for computer operations. In addition, the Commission oversees five (5) major fishery data bases which require additional servers, software, and maintenance support. Some of the fishery data bases required specific software licenses (Ingress, Oracle, Sun) which other Commission activities did not require. The process established for recovering these costs was based on the general activities all Commission staff required (PC support, internet connections, Commission firewalls, spam software, UPS backup, generator) and project specific needs (Ingress, Oracle, Sun software), and the computer services department staff time and effort. The data base projects were assessed a computer service fee based on number of PC's needing support and their specific software, licenses, maintenance needs. The Commission was also assessed a computer service fee for the support needed for the personal computers and servers identified for the indirect cost activities (accounting, payroll, human resources, administrative support staff).

After discussions with the auditors during their visit, we have revisited the Computer Services distribution of costs. The data projects that have specific needs (Oracle, Ingress, Sun), those needs are charged directly to the projects. The costs for the computer services department to operate the Commission computers used in the administrative support of the organization are included in the indirect cost activities.

**B. The Commission Had Not Developed Adequate Indirect Cost Methodology, Policies, Procedures, and Controls.**

The methodology used by the Commission is the same methodology established and approved in 1986 by the Department of Commerce and again in 1994 by the Bonneville Power Administration. The Commission has definitely experienced growth since 1994, but the underlying components are still the same. The Commission staff that performs the administrative services that cannot be assigned solely to a direct program (payroll, accounting, contracting, Executive Director, human Resources, secretarial support) are what comprise the Commission indirect cost pool. The Commission used a simplified, modified direct cost approach. The Commission has an annual audit performed as required under A-133, and based on the financial data in the report; an indirect cost rate is calculated for the fiscal year. A Certificate is completed, supporting documentation on file, and a copy of the Certificate and indirect cost rate support sent to our oversight agency.

The costs associated with the indirect cost allocation plan are based on A-87, unallowable costs were excluded, however, not as readily apparent to an outside party, so definitive general ledger codes were established (Attachment 12).

We have been working with a consultant to refine our existing indirect cost plan methodology; however, with the growth we have experienced, it may be time to redefine the underlying methodology. A Request for Proposal is being drafted to acquire a consultant for this purpose to analyze and recommend the approach the Commission should apply in the future.

#### **C. The Commission's Indirect Cost Method Failed to Equitably Distribute Indirect Costs**

The Commission methodology was established in 1986 and we have experienced significant growth through the past 25 years. This growth could have an impact on the basis for calculating indirect cost rates, therefore, we are distributing a Request for Proposal to have a consultant do an in-depth analysis of the Commission's indirect cost methodology and suggest changes based on the activities the Commission is currently engaged in. With the methodology that was established in 1986, the application of this rate is consistently and equitably distributed.

#### **D. The Commission did not Adjust Fixed Indirect Cost Rates to Reflect Actual Costs**

The chart which identifies indirect cost rates used during the period 2002-2008 and asserts that none were "Accepted by Audit." This statement is contrary to the opinions and reports issued by the Commission's independent auditors for those same periods.

The Commission applies a fixed carry-forward indirect cost rate based on prior year's actual expenditures. For a period of time, the Commission experienced a fluctuating base due to unusual circumstances, so our rate would vary from year to year. There were years we under collected based on actual costs and years we over collected on actual costs. The percentage from year to year could vary anywhere from .1% to 3%. As noted on page 10, Table 1: Indirect Cost Rates Proposed and Accepted by Audit, in the years 2002 to 2006 the indirect cost rate claimed by the Commission versus actual indirect cost rate proposed by the Commission in January 2009 the rate bounded around while the level of projects the Commission was administering was unstable. Unsure if the fluctuation would be a temporary or permanent, we continued to carry forward the difference for a few years. In 2005 we addressed the issue by reducing our rate from 15% to 13%. Since 2006, we have been proactive in adjusting our rate on an annual basis based on the actual costs. Because the revenue generated from indirect cost is the only funding available to pay for the administrative support functions of the organization, at times we may have a slight cushion to our rate. If the Commission should under recover, there is no other source of funds to cover the expenditures incurred to administer these awards.

### **III. Conclusion**

The Commission did prepare and support their indirect cost rate for the years in question 2002-2008. This information was kept on file as required in OMB A-87, Attachment E, Section D.1.b, also as noted in the Department of Commerce Financial Assistance Standard Terms and Conditions. When we were contacted in April 2008 by our NOAA Federal program Officer that DOC had issued revised guidance for submittal of Indirect Cost Rates, we submitted on May 1, 2008 our Certificate to the Department of Commerce Office of Acquisition Management, Indirect Cost Program and received a reply on May 8, 2008 that it had been accepted. Each year thereafter, the Commission has submitted this Certificate as suggested in the revised guidance issued in April 2008.



The statement made in Section III Conclusion, paragraph 3 (page 11), that NOAA Grants Officer should disallow any indirect cost claims subsequent to the audit period for which Commission has not corrected the deficiencies described is highly problematic.

If the Commission were not allowed to claim indirect cost, we would have to notify all awarding agencies that the Commission would need to curtail work until this issue is resolved. The indirect cost that the Commission claims and receives for administering these awards is the only funding generated to pay for the support staff that provides the services necessary to complete the administrative and financial aspects of these awards (payroll, accounting, human resources, contracting, see Attachment 18).

We would be curtailing work on the projects that collect and manage critical data on the Pacific coast marine recreational fisheries in order to better meet State and Federal fishery management needs. This includes the Recreational Fisheries Information Network which is a coordinated fishery data collection, analysis and monitoring program which seeks to integrate state and federal recreational data collection programs under one umbrella. Accurate and timely catch statistics, along with associated biological and economic studies, provide management agencies with the information necessary to plan for the wise use of the fishery resources. It also provides for monitoring in support of state and federal management plans for the recreational component of Pacific fisheries.

In addition, the Commission administers the West Coast Groundfish Observer Program whose main goal is the collection of coast wide, year round discard rates for the groundfish fisheries of the West Coast of the United States to determine total mortality estimates. With the large number of groundfish species which are overfished and the fact these overfished species are part of mixed catches in highly variable numbers requires the use of at sea observers to quantify discards rates on a variety of groundfish vessels and fisheries. The West Coast Groundfish Observer Program is the only active source for data on discard rates for the groundfish fisheries of the West Coast of the United States.

Another example of a program that the Commission administers that would be curtailed is the Observer/Compliance Monitor Support program. The Pacific Fishery Management Council, the organization responsible for coordinating management of fisheries off California, Oregon, and Washington adopted a new management system for the groundfish trawl fishery which will dramatically change state and federal management of west coast groundfish fisheries and may affect other fisheries that harvest groundfish as bycatch. This new system is a trawl individual quota program (IFQ), which is a specific portion of a fishery's total harvest limit that can be harvested solely by the individual or business holding the IFQ. The Commission is developing tracking and monitoring tools that build on existing state and federal programs as well as are associated with other projects that the Commission is involved with.

These projects identified above are just a few of the programs the Commission administers that would be jeopardized if the NOAA Grants Office were to preclude recovery of any indirect cost to be claimed as recommended in the draft audit report.

#### IV. Subsequent Events

The fiscal year ending June 30, 2009 the Commission proposed an indirect cost rate of 13%, recovering costs of \$1,151,951 from Commerce and \$997,155 from federal sources. The report states that it was based on 2009 proposed indirect cost rate on an unacceptable computation from 2008. And that no support was provided for the administrative fee.

As we have continually addressed throughout this response. The Commission indirect cost rate is supported by the financial data provided in our A-133 annual financial audit. All the subsidiary ledgers were provided at the time of the audit and are attached to this document for an additional review. Since the preliminary rate of 13% was established from the 2008 data, a revised rate of 12.38% was applied based on actual expenditures supported by the financial data presented in our A-133 financial audit.

The 2% administrative fee for pass-thru funds to our member states is an accepted and approved rate as noted in the Indirect Cost Rate Agreement with Bonneville Power Administration. The basis for this rate had not changed. The rate is applied to all pass-thru funds to our member states, at the end of the fiscal year, the amount collected in revenue has an equal amount of expenses deducted from our indirect cost activities, which reduces the indirect cost rate to be applied to all other direct costs.

The report states that "we do not accept the Commission's indirect cost rates or administrative fees for fiscal years 2002 through 2008." Such statement implies that it is the prerogative of the Office of Inspector General to disallow such costs as opposed to questioning them. We request that the report be revised to reflect, consistent with Section 106(d) of the Inspector General Act Amendments of 1988, that Department of Commerce management is the responsible party for disallowance and, as noted throughout this submission, that the Commission vigorously contests that necessity.

As stated above, if the NOAA Grants Officer should not accept indirect cost claims subsequent to 2008, the Commission would be unable to support their indirect cost support services which administer these federal funded programs (payroll, human resources, accounting, contracting).

#### V. Recommendations

As stated throughout this document, we disagree with the recommendations proposed by the Inspector General staff for the following reasons:

1. The Commission is complying with the minimum federal financial management standards by:
  - a. Implementing a cost accounting system ensures that all direct projects are identified, assigned a separate project (job) number (Attachment 13), related expenses and revenues are tracked, and each project received a fair share of indirect costs based on direct costs.
  - b. Developing and documenting indirect cost methodology that has been used since 1986 and accepted by Department of Commerce and Bonneville Power Administration. A process was used for identifying and excluding unallowable costs, however, we have implemented a more visible process by establishing additional general ledger codes for the unallowable costs as identified in A-87 and a separate job number (100U).

- c. Establishing a process and procedures to develop, support, and subsequently adjust indirect cost rate proposals to actual. We request that the word "submit" be removed from the text to make it consistent with Appendix E, Paragraph D.1.b of Circular A-87.
  - d. Documenting the indirect cost rate proposals and certifications and submitted data in accordance with the revised guidance released by the Department of Commerce in April 2008. This information is being supplied to the appropriate authority as identified in the guidance. Copies of the Commission's indirect cost rate are submitted with each grant proposal and the NOAA Grants Office has access to those submittals.
2. Commission indirect cost rate plans have been developed and were handled as instructed by NOAA Grants Office staff, and by Office of Inspector General staff who conducted the previously referred to audit in 2002, and according to procedures for state and local government agencies as defined in OMB Circular A-87, Attachment E, Section D.1.b.

At the exit interview a request was made of the auditors for a detailed list of questioned costs so that such items could be researched fully and handled properly by the Commission (Attachment 17). A second request was made in a follow-up e-mail. No documentation was provided by the auditors to assist with either of these requests. This request was never responded to and it is difficult for the Commission staff to ensure they have addressed all questionable items unless we have been informed to of what the specific items are. Based upon conversations and e-mails exchanged during the audit, we have reviewed all the data from 2002-2008 associated with our indirect cost activities and removed items that may be questionable and recalculated the rates based on this data.

3. Suspend payment of indirect costs under all current awards and prohibit recovery for future awards until the Commission develops and negotiates acceptable indirect cost rates.

Based on the current process identified in the recent DOC guidance, we have followed the process; our rate was accepted by the DOC Office of Acquisition Management, Indirect Cost Program. If payment of indirect costs is suspended, the notification to curtail all work will be released by the Commission since they will have no revenue to cover the costs of the indirect cost services utilized by these projects. We believe the indirect cost rate as currently being calculated and assessed is reasonable.

4. The Commission 2% administrative assessment for pass-thru funds is reduced from the indirect cost activities at the end of each fiscal year. Due to the offset, there is no duplication of the Commission indirect cost recoveries. These indirect cost activities include contracting and accounting services. As addressed above, the data processing assessments has already been changed. The administrative fee for the fishery disaster programs is a separate topic to be addressed due to the uniqueness of the services we provided for these programs.
5. Recommendation 5 should be revised to include, among the matters about which the Department of Commerce may choose to notify other federal agencies, the disposition decisions that Commerce made about any findings that remain in the final audit report.



**Response to Appendix A: Objectives, Scope, and Methodology**

In Appendix A it states that this examination was a "performance audit" conducted in accordance with generally accepted government auditing standards. However, given the nature of the audit objectives identified on pages 1 and 2 of the report, the Commission questions this characterization and suggests that the audit actually meets the criteria of Section 1.22b of the standards for a financial audit .

**Response to Exhibit B: Detail of Indirect Cost Audit**

**A. The Commission Treated Bonuses Inconsistently and Charged Expenses on a Cash Basis**

**1. Bonus payments:**

The Commission established a pay for performance compensation process in 2006 which was a change from the annual cost-of-living and base pay adjustment process used in the past. The Commission wanted to ensure that all projects had a Program Manager assigned to them to have management representation for any programmatic issues that would occur. These Senior Program Managers are supervised by the Executive Director and are providing a valuable oversight for the Commission on these projects. This additional responsibility was for the benefit of the Commission; therefore the bonus payments were included in the indirect cost pool.

- 2. Cash Basis for Expenditures:** There are several items that the Commission incurs throughout the year in which we are billed on an annual basis, which often produces a savings when paid in a lump amount. These items may include software maintenance, support for hardware, annual maintenance for services (copiers, computer servers), which the Commission fully expends to the current funding year.

Generally accepted accounting principles (GAAP) are established by the Governmental Accounting Standards Board (GASB). Governmental funds expend resources for a variety of purposes. In general, the purchase of supplies and material consumes financial resources and should be recorded as expenditures when purchased. This is known as the purchase method of accounting. Governments are also allowed to use the consumption method of accounting for inventories. This method is similar to what a commercial business would use. Expenditures will be reported when materials and supplies are used, not when purchased. Governments may also use either the purchase or consumption method to report the prepayment of certain costs such as insurance.

The Commission uses the purchase method of accounting for prepaid assets with a life of one year or less; the same as our capitalization policy for non-expendable tangible personal property (Attachment 15). Accordingly, under governmental accounting standards and Commission policy, the basis of accounting was appropriate.

**B. The Commission Charged Unallowable Costs to the Indirect Cost Pool**

- 1. Necessary and Reasonable Costs** – The auditors review for fiscal years 2002 through 2008 revealed that the Commission had leased a vehicle for the Executive Director and the costs included the monthly lease payments, insurance, repairs and maintenance.

The Commission does not have the availability of a motor pool for the Executive Director's use when traveling to meetings, picking up guests at the airport and transporting to the Commission office, so a leased vehicle is provided. Over a span of 7 years, the total cost has been \$75,689

which equates to roughly \$10,812 per year. If a motor pool was available for the Commission, the cost would run about \$9,800 /year.

Personal use of the Commission vehicle by the Executive Director has been reported as taxable wages on Form W-2. This equates to approximately \$4,000 per year. The Executive Director must complete an Annual Lease Valuation Report declaring business and personal miles driven. A sample form is attached (Attachment 16). It is the Executive Director's responsibility to maintain records necessary to permit accurate completion of the mileage record tax form. The Executive Director has been advised that a mileage log must be kept and provided to Commission staff annually. Alternatively a monthly car allowance may be negotiated in lieu of a Commission provided vehicle.

It is unclear the basis for the auditor statement of excluding a taxable fringe benefit from the indirect cost pool.

2. *Direct Cost Charged to Indirect Cost* – One of the programs that the Commission administers for Bonneville Power Administration is the Northern Pikeminnow which pays individuals for removing salmon predators from the river. This program that has a tiered payment system based on the number of Northern Pikeminnow fish caught during the fishing season plus a defined amount for each tagged fish. The volume of this program is high during a very short period of time (May – September). This has been an ongoing program and was originally established on the Commission's accounting system in 1997. The Commission's accounting system was upgraded in 2002, but the Northern Pikeminnow program remained on the old system due to customizations required to address the tiered payments. Costs incurred in June 2002 for accounting customizations to upgrade the Northern Pikeminnow program to the new accounting system were originally charged to indirect but on August 18, 2009 those costs were reclassified to the Northern Pikeminnow program as a direct expenses.

Commission front office staff has helped coordinate conferences and meetings for NOAA over the past few years. We anticipated the amount of time staff would expend on these conferences to be minimal. However, as these conferences became more demanding of staff time, it became apparent that we would need to negotiate with NOAA to include staff funding for these projects. During 2010 the Commission coordinated three major conferences/meetings for NOAA and staff that was involved has directly charged their hours to these activities. Accordingly, the indirect cost pool is not covering their time spent on these activities.

3. *Inadequate Documentation of Costs* - As part of the audit, there was some individuals who did a better job documenting their expenses (who, what, where, why) than others. The costs the individuals were seeking reimbursement for were allowable, but the level of documentation was weak. For some, the administrative burden for justifying their expenses is not their strongest attribute. We have recognized this and assigned an administrative support staff member to help gather the necessary documentation for these individuals. The travel and reimbursement process for employees was a manual paper reimbursement process. Employees seeking reimbursement were required to complete a claim form, submit receipts in compliance with policies and rules. It was apparent that with the growth of the Commission the volume of requests and review and monitoring these requests was creating a burden on staff. In 2010 we implemented the use of an electronic travel reimbursement process (Concur), which has the

Commission travel policies and rules embedded into the software. The Company who hosts the software, updates the GSA per diem limits, as needed, so travelers are reimbursed up to the limits we have identified in our policies. The system generates a list of required receipts that the traveler must provide before submitting their claim for reimbursement and approval.

4. *Undocumented and Excessive Travel Costs* – The Commission had established a travel policy based upon the Federal travel regulations, however the Commission travel policy did not adopt the federal travel regulations in a few areas nor is it required to do so (OMB Circular A-87, Appendix B, Paragraph 43). The travel policy was not clear in that regards, so we have readdressed the Commission travel policy, and had it reviewed by a Consultant who has significant knowledge and understanding of Federal Grants, Cooperative Agreements, and Financial Assistance Awards. The updated travel policy has been finalized and released to employees (Attachment 14). One objective was to clarify what type of documentation is needed depending on the type of travel (overnight, day, or local trip) and assure costs charged to federal programs either directly or indirectly are necessary and reasonable for proper and efficient performance and administration of federal awards.

In addition, to insure compliance with Commission travel policy, electronic travel claim software with a GSA module has been implemented. The software will assist employees in obtaining government rates, where possible. Rules have been designed within the software to require justifications for exceptions to the Commission travel policy.

We have defined a process for ALL employees to submit travel claims whether the Commission owes them any funds or not, so travel can be documented and subjected to travel policy rules (e.g., if meeting expenses were put on a "master bill", an employee who attended the meeting must still submit a "\$0" travel claim showing that they attended the meeting). This policy also applies to the Executive Director. All travel charged to direct or indirect must be within the per diem limits, unless a valid justification for exceeding the limit is documented.

5. *Entertainment Costs* – As noted in Circular A-87, Employee Health Wealth and Morale, the Commission during 2002 through 2008 took the opportunity at the end of the year to "thank" employees for their service during the year with Time of Service Awards as noted in the PSMFC Personnel Manual, Employee of the Year, and for a job well done.

The auditors noted that the Commission calculated \$30,722 was paid for annual holiday events between 2002 and 2008; however, they identified a total of \$40,790 and stated that they believe the actual total to be higher. The Commission had, in fact, identified a higher amount totaling \$46,630. The amount provided the auditors, \$30,722, was the portion charged to the indirect cost pool. Per the auditors' request, we provided a detail listing of all general ledger expenditures. Expenditures are coded to program or non-program cost centers, however, not all non-program cost centers are included in the indirect cost pool. We suspect the auditor total of \$40,790 includes costs excluded from the indirect cost pool. The auditors did not discuss this issue with staff during the audit. If the auditors had provided the requested detail of questioned costs, the Commission would have been able to research and constructively respond to the issue during the audit. Conduct of employee health, morale, and welfare activities are allowable when incurred in accordance with the governmental unit's established practice or custom for



the improvement of working conditions, employer-employee relations, employee morale, and employee performance. These costs are not unallowable entertainment costs

6. *Capital Expenditures Charged to Expenses* – An extensive analysis of capital assets acquired over seven years was performed to identify assets requiring capitalization under the Commission's \$1,000 threshold. The search engine mentioned in section 6 Appendix B was a Google product and recorded in the accounting system as software. Accordingly, it did not appear in the recalculation. A discussion can be had whether the cost is hardware or a licensing agreement to utilize Google search technology, but the discussion during the audit about the item was brief and inconclusive. At the exit interview a request was made of the auditors for a detailed list of questioned costs so that such items could be researched fully and handled properly by the Commission. A second request was made in a follow-up e-mail (Attachment 17). No documentation was provided by the auditors to assist with either of these requests.
7. *Contributions* – To segregate unallowable costs, we have established specific general ledger (G/L) codes as specified in A-87. Specifically, contributions are now coded to general ledger account 50040. We have reviewed all the financial data from 2002-2008 and removed any items that could be questionable and assigned them to the new G/L codes under a separate Job numbers identified as unallowable. See attached copy of general ledger codes (Attachment 12-50000 series).
8. *Lobbying Costs* – The Commission entered into an agreement with a legal firm in Washington DC to help with the federal budget process and securing funding for our member states. The law firm is on a retainer of \$4,000/mo (\$48,000/year) and each month the law firm identifies on their bill how much of their invoice is for lobbying. Normally, the lobbying activities occur in the January – March of each year when Congress is dealing with the federal budget. This law firm also helps with specific legislation with regards to fisheries (Reauthorization of Magnuson Act, Marine Mammal Protection Act, Ocean Policy), and keeps the Commission's Executive Director and Member States advised of any new legislation or policies, that could impact the fisheries on the West Coast. We have discussed with the law firm that their invoices need to identify hours incurred for lobbying activities (based on their tracking logs). The restrictions on lobbying costs contained in OMB Circular A-87 are not comprehensive and are limited to those related to those intended to obtain federal awards or executive branch agency consideration not based on the merits of the matter. Segregation of such costs along those lines will be accomplished in the future.
9. *Bonus Payments Inadequately supported* – The Commission's Executive Director supervises the Program Managers and Executive Staff, and performs their annual performance reviews. While the auditors were conducting their field work, it became evident that the supporting documentation for several years of reviews had not been forwarded to the Human Resource Manager for filing. These reviews have been forwarded to the HR Manager and filed in the appropriate employees personnel file.

10. *Salary and Bonus Cost Charged to Incorrect Project* – The Commission has an electronic time keeping system that employees post their hours worked to the various projects they are assigned to. Each employee has a home department which encompasses their main assignment and they may also have job transfer codes if their position is required to work on other projects. The employee's hours are captured in the time keeping system, downloading into the payroll module, and then extracted to the accounting system and allocated to the various projects as identified on the timesheet. The benefits for these individuals are distributed to the projects (job numbers) based on hours worked. The Commission support staff perform a variety of tasks associated with the operation of the Commission office. These tasks include basic operational tasks and support to other project staff members. Each program the Commission administers has different support needs depending on the type of tasks associated with the program. There may be times when the support staff is spending more time with one project manager than another, but they are not providing programmatic support, their efforts are funded through the Commission's indirect cost pool. When support staff is requested to provide an increased level of assistance, we have requested the staff segregate their hours to these direct programs.

Over the past few years our front office staff, has been asked to assist with meeting preparation which includes securing meeting sites, logistics, and staff at the meeting to ensure that all aspects during the meeting occur without interruption to meeting participants. When we were first engaged to perform these activities, staff time was not directly identified to the project, which can encompass a week or two of staff time. As the level of NOAA requested assistance has increased, we have worked with the funding agency to provide sufficient financial support so that the Commission can direct cost their administrative support staff during these activities to the project.

When the Commission was approached in 2006 to manage the first Fishery Disaster program, there had been significant delays with the overall declaration of the disaster, appropriation of funds from Congress, and securing a mechanism for disbursing these funds to the eligible fishermen. To ensure that the maximum amount of funds were given to the impacted fishermen and businesses, and since the Commission had only an approved indirect cost rate of 13% or a 2% pass-thru rate, it was agreed by all parties, that the Commission would not direct cost staff or charge the 13% indirect cost rate, but would charge the 2% pass-thru rate on this NOAA Award. Any staff time or other direct expenses (postage, copying, etc.) would be funded with the 2% pass-through rate. A separate job number was assigned for these expenses (215DR) and these costs were excluded from the Commission's indirect cost rate. In the beginning, Commission administrative support staff did not segregate their hours to this program. However, as the level of effort became apparent, support staff were instructed to segregate their hours and they would be supported with the 2% pass-thru rate (charged to job 215DR).

#### PSMFC SUMMARY

The Commission has taken corrective actions on a number of matters that were called to our attention during the audit. However, we do not believe it is appropriate to commit to correct conditions that we do not agree are deficient in anything approaching the degree to which the draft audit report asserts that they are. Our organization is committed to proper stewardship of the federal funding we receive and to the accomplishment of the important program objectives that those funds support.



The Commission's accounting system offers the necessary accounting framework, which defines projects and costs as direct or indirect and provides for identification and segregation of allowable and unallowable costs. The Commission's issues a job number to each project that we administer (see attached list of Commission Job Numbers assigned to each specific project-Attachment 13). When that job number is assigned, it is assigned in the cost accounting system as an indirect or direct project. A specific job (100U) is set up for unallowable costs (per A-87) and these costs are not included in either direct or indirect allocations. In discussions with the Inspector General staff, it was apparent that it would be more understandable to an outsider if we had specific general ledger cost codes as defined in A-87 for unallowable costs (contributions, alcohol, fines, etc) so we have established new general ledger codes for these type of expenses (see Attachment 12). It was also apparent during this audit, that all jobs associated with indirect should be in their own series of numbers (200's), so we will be changing the one job assigned to a project within that series to a new job number when the contract comes up for renewal, therefore it will be clean break for indirect and direct job numbers.

The Commission has went to extraordinary lengths over an extended number of years to clarify the facts that it was not required to submit its indirect plans to the Department of Commerce. This effort was undertaken despite clear instructions contained in OMB Circular A-87 (Appendix E, Paragraph D.1.b) that those organizations not specifically and formally assigned a cognizant agency by the Office of Management and Budget need not submit their plans but are to retain them and the supporting documentation for audit and reinforcement of that policy in section 3B of the annual *Compliance Supplement for Circular A-133 Audits* issued by OMB, which discusses the independent auditor's responsibility for review of indirect costs when no submission to a federal agency is required.

The methodology used by the Commission is the same methodology established and approved in 1986 by the Department of Commerce and again in 1994 by the Bonneville Power Administration. The Commission has definitely experienced growth since 1994, but the underlying support service components are still the same. The Commission staff that performs the administrative services that cannot be assigned solely to a direct program (payroll, accounting, contracting, Executive Director, human Resources, secretarial support) are what comprise the Commission indirect cost pool. The Commission used a simplified, modified direct cost approach. The Commission has an annual audit performed as required under A-133, and based on the financial data in the report; an indirect cost rate is calculated for the fiscal year. A Certificate is completed, supporting documentation on file, and a copy of the Certificate and indirect cost rate support sent to our oversight agency.

The costs associated with the indirect cost allocation plan are based on A-87, unallowable costs were excluded, however, not as apparent to an outside party, so definitive general ledger codes established (see Attachment 12).

We have been working with a consultant to refine our existing indirect cost plan methodology; however, with the growth we have experienced, it may be time to redefine the underlying methodology. A Request for Proposal is being drafted to acquire a consultant for this purpose to analyze and recommend the approach the Commission should apply in the future.

The Commission has updated its travel policy (Attachment 14) to clarify what type of documentation is needed depending on the type of travel and assure costs are charged to federal programs either directly to indirectly, and are necessary and reasonable for proper and efficient performance and administration

of federal awards. In addition, to insure compliance with Commission travel policy, electronic travel claim software with a GSA module has been implemented. The software will assist employees in obtaining government rates, where possible. Rules have been designed within the software to require justifications for exceptions to the Commission travel policy.

We have defined a process for ALL employees to submit travel claims whether the Commission owes them any funds or not, so travel can be documented and subjected to travel policy rules (e.g., If meeting expenses were put on a "master bill", an employee who attended the meeting must still submit a "\$0" travel claim showing that they attended the meeting). This policy also applies to the Executive Director. All travel charged to direct or indirect must be within the per diem limits, unless a valid justification for exceeding the limit is documented.

Based upon conversations and e-mails exchanged during the audit, the Commission staff has revised all the data from 2002-2008 associated with our indirect cost activities and removed all items that may be of question, and recalculated the rates based on this data. We are prepared to provide this detailed data if requested in order to resolve this audit. The Commission provides a valuable service to our member states and federal partners. The service we provide is efficient and cost effective with an indirect cost rate ranging from 12.38% to 15% over the past 25 years. We value the opportunity to improve whenever and however needed to be able to provide the services needed to collect and manage critical data on the Pacific coast marine recreational fisheries in order to better meet State and Federal fishery management needs.

## **Appendix D: OIG Comments on Commission Response**

OIG reaffirms our conclusion that the Commission did not comply with the minimum requirements necessary to recover indirect costs. Consequently, all indirect costs claimed by the Commission during the audit period are called into question; none of the \$15.6 million in indirect costs or the \$2.9 million in administrative fees recovered by the Commission during that period is allowable for federal participation. We also reaffirm our recommendations to the NOAA Grants Officer. This appendix discusses the basis for our findings and directly addresses the Commission's response, which is available at our office.

As a longtime recipient of federal financial assistance, the Commission has significant experience with federal cost principles, including those principles requiring the preparation of indirect cost rate proposals, certifications, and adequate supporting documentation in order to claim indirect costs. Yet even though its previous indirect cost agreement lapsed around 1997, at the time of our audit—13-plus years later—the Commission still had not negotiated a new agreement, despite its acknowledgement that it had experienced significant growth. Likewise, although the Commission claims that any disallowance of its funding would have an adverse effect on its work, it risked disallowance by choosing not to revise its indirect cost rate despite its familiarity with federal principles regarding indirect cost claims. In January 2009, the OIG audit team found such serious deficiencies that we delayed our audit to allow the Commission to develop revised cost proposals, methodology, and policies. Even with the additional time, the Commission produced inadequate proposals that did not equitably distribute indirect costs.

Moreover, in preparing its response to our draft report, the Commission again did not provide necessary details and supporting documentation for its assertions that it has revised its indirect cost rate proposals for the audit period. Had it done so, we would have evaluated those actions and may have been able to credit the Commission with those accomplishments in this final report.

### **Finding I: The Commission Did Not Submit, Certify, or Adequately Support Indirect Cost Rate Proposals**

Despite multiple notifications by the Department of Commerce, the Commission did not submit, certify, or adequately support its indirect cost rate proposals as required in order to claim indirect costs. The Commission disagreed with our finding because, it claimed, it had not been formally notified that Commerce was the cognizant federal agency for indirect cost, Commerce did not request the submission of indirect cost rate proposals, and Office of Management and Budget (OMB) Circular A-87 did not require it to submit its proposals. OMB does not specifically designate cognizant agencies for indirect cost for all federal grantees, including the Commission; however, as the Commission's primary federal funding source since 2003, the Department of Commerce is clearly cognizant for the Commission's indirect cost, in accordance with the following provisions of OMB Circular A-87, attachment E at section D.1.b.:

...The cognizant agency for all governmental units or agencies not identified by OMB will be determined based on the Federal agency providing the largest

amount of Federal funds. In these cases, a governmental unit must develop an indirect cost proposal in accordance with the requirements of this Circular and maintain the proposal and related supporting documentation for audit. These governmental units are not required to submit their proposals unless they are specifically requested to do so by the cognizant agency....

The Commission had multiple opportunities to submit its indirect cost proposals and supporting data over the years:

1. The Department's financial assistance agreements, executed by both the National Oceanic and Atmospheric Administration (NOAA) Grants Officer and the Commission, not only incorporated OMB Circular A-87 by reference but also included other indirect cost requirements fully consistent with the circular.
2. NOAA's award notification letters accompanying its financial assistance offers clearly include directions to the Commission to follow the Department's *Financial Assistance Standard Terms and Conditions* pertaining to indirect cost, which are incorporated by reference in each award. Those provisions set forth submission and support requirements for indirect cost rate proposals.
3. The Department of Commerce pre-award notification requirements for grants and cooperative agreements, published in *Federal Registers* spanning the audit period, provide specific instructions directing the submission of indirect cost rate proposals and supporting documentation. These requirements are incorporated by reference in NOAA financial assistance awards.
4. NOAA's *Administrative Standard Terms and Conditions* contains specific provisions addressing expired indirect cost rates and directing award recipients to submit a request to renegotiate the indirect cost rate agreement, along with required documentation, to their cognizant federal agency to update their negotiated rate agreements. These provisions are included in each financial assistance award.

The Commission's previous negotiated indirect cost agreements, dated 1986 and 1996, have long since lapsed. As we reported, the 1996 agreement with the Bonneville Power Administration covered rates for 1993 through 1997. The Commission asserts that its methodology was accepted at that time and has not changed in the intervening years—despite the Commission's significant growth, addition of new programs and activities, and indirect cost rate proposals that show the contrary. When we requested its indirect cost methodology and costing policy in January 2009, the Commission was unable to produce an approved methodology that was still applicable for the audit period. We then suspended the audit—in part to give the Commission an opportunity to develop the methodology and policy—but when we resumed the following March, neither the methodology nor the policy were available.

Initial testing of the rates provided to us in January 2009 disclosed serious deficiencies in the Commission's rate proposals. When we suspended the audit that month, we allowed the Commission to prepare revised proposals, which it provided in late March 2009. Preliminary

testing of the revised proposals demonstrated that they were still inadequate for reasons detailed in this report; therefore, we questioned the rates as they had been calculated and applied.

At the time of our audit, the Commission was only able to provide an indirect cost rate certification for its fiscal year 2007, and it prepared the certification for 2008 while we were on site. Commission management advised us that there were no indirect cost rate certifications prepared for the other years in our audit period. The certificates for fiscal years 2002 through 2006 (which the Commission included in attachment 7 of its response) were for cost allocation plans<sup>35</sup> rather than indirect cost rate plans;<sup>36</sup> therefore, these certifications are not applicable.

As we reported in appendix A, we met with the Commission's independent auditors and reviewed the work accomplished in support of the Commission's single audits to determine the extent to which our audit could build upon that work. Contrary to the Commission's statement that the indirect cost rate is calculated on an annual basis as part of the Commission's A-133 annual financial audit, representatives of the Commission's audit firm confirmed that the Commission's single audits did not include review of the indirect cost rate proposal beyond ensuring that the rates charged to federal awards agreed with the rates proposed.

The Commission also asserted that by accepting and approving its final financial status reports, the Grants Office did not disallow any portion of the indirect cost charges identified in the reports. However, a Grant Officer's acceptance and approval of such reports in the award close-out process does not affect a federal agency's right to disallow costs and recover funds on the basis of a later audit or other review.<sup>37</sup> More specifically, refunds are required where indirect cost rate proposals are later found to have included unallowable or unallocable costs.<sup>38</sup>

## **Finding II: The Commission's Unsubmitted Indirect Cost Proposals Were Inadequate, and Rates and Claims Were Unallowable**

The Commission disagreed with our finding, contending that the application of its indirect cost rates produced consistent and equitable distributions of indirect costs, and the indirect cost rate proposals included as attachment 7 of its response are (with a few minor exceptions) the same as those provided to us in January 2009. However, the Commission also acknowledged that it had revised, or was planning to revise, its handling of numerous activities to ensure equity in the future. For the many reasons detailed in our draft report and reaffirmed here, both groups of indirect cost rate proposals provided to us in January and March 2009—and thus the rates and indirect cost claims based on these proposals—are not allowable for federal participation due to the inclusion of unallowable costs, use of inconsistent costing policies, and inequitable distribution of costs to projects. We also specifically note that the Commission's proposals clearly demonstrate inconsistency in its handling of data processing fees, offsets for 2 percent administrative fees, and carry-forward adjustments.

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<sup>35</sup> OMB Circular A-87, attachment C at E.4.

<sup>36</sup> OMB Circular A-87, attachment E at D.3.

<sup>37</sup> *Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments*, 15 CFR § 24.51(a).

<sup>38</sup> OMB Circular A-87, attachment E at E.4.



In its response, the Commission referred to shifting time between projects to correct employee coding errors. While we had no objections to these corrections, we did disagree with the Commission's decision to override the actual hours recorded by employees in its time distribution system and instead charge time to projects based on budgeted percentages, or adjust blocks of time between projects. Because direct labor is a part of the modified total direct cost base the Commission uses to allocate indirect cost to projects, such shifts not only produce inequitable distributions of indirect cost to projects but also, as demonstrated in our report on two of the Commission's cooperative agreements, can result in unallowable claims of indirect cost in excess of the approved budget line items.

The Commission also downplayed the initial impact of indirect costs that had been misclassified as direct. But improper identification can overstate the indirect cost pool, understate the modified total direct cost base, increase the indirect cost rate, and possibly inequitably distribute the cost of the direct activity to other projects.

The Commission's consistent implementation of its cost accounting system should not be influenced by the choice of billing mechanisms used for any project (such as the fisheries disaster awards or the suite of State of California projects). All projects should be assigned a job number and must follow the same cost accounting method, recording all direct costs applicable to the job and applying the Commission's indirect cost rates. Revenues should be credited to the project cost account. Project losses due to the use of an inadequate billing method cannot be transferred to other projects or recovered through the indirect cost rate.<sup>39</sup> Because the Commission is a regional government entity and because it operates cost-reimbursable awards, any gains must be returned to the funding source. Furthermore, project gains and losses cannot be used to offset indirect cost without producing unallowable, inequitable distributions to the remainder of the Commission's projects.

If, as the Commission asserts, activities such as the fisheries disaster projects, the State of California suite of projects, and pass-through awards demand different levels of administration, in the future it may wish to consider whether a multiple-allocation-base indirect cost method or special indirect cost rates better address those differences. Whatever course the Commission chooses, it must adhere to OMB guidance. Unsupported assessment rates that are not subsequently reconciled to actual costs, such as the 2 percent applied to the fisheries disaster awards and pass-through activities and the fees attached to the suite of State of California projects, are not allowable.

The Commission also asserted that its application of the 2 percent ancillary fees was covered under OMB Circular A-87, attachment A at section A.2.b. Alternative reimbursement systems for administrative costs are acceptable only if the fees generated are periodically reconciled to actual costs,<sup>40</sup> but the Commission had no such provision for fee reconciliation. Furthermore, fee-for-service tests must be worked out with federal funding agencies as an alternative, rather than a supplementary, mechanism for paying administrative costs. Such arrangements are

<sup>39</sup> OMB Circular A-87, attachment A at C.3.c. and F.3.b.

<sup>40</sup> OMB Circular A-87, attachment E at A.3, and *A Guide for State, Local and Indian Tribal Governments: Cost Principles and Procedures for Establishing Cost Allocation Plans and Indirect Cost Rates for Agreements with the Federal Government*, ASMB C-10 at 2.11, 2-1.

intended to reduce the burden associated with maintaining systems for charging these costs to projects and preparing and approving cost allocation plans. If the Commission intends to pursue this method in the future, it should consult with the Department's Indirect Cost Coordinator to determine an acceptable alternative mechanism to its indirect cost rate.

The Commission contended that, by adjusting its indirect cost pool by the amount of ancillary fees collected on pass-through funds, it eliminated the potential for duplicate recovery of the costs to administer pass-through activities. These costs are included in the indirect cost pool and distributed to all other direct projects. However, the Commission did not use the administrative fees it collected as an offset to the indirect cost pool until its fiscal year 2006. This is just one of the reasons that the indirect cost rates for fiscal years 2002 through 2005 were determined to be inequitable. Administrative fee recoveries for 2002 through 2005 ranged from \$225,169 to \$255,367, according to the Commission's indirect cost rate proposals.

From 2006 through 2009, the Commission offset the indirect cost pool by the amount of administrative fees it collected on pass-through funds. However, as we have demonstrated, because the Commission does not identify the administrative expenses associated with pass-through activities, there is no assurance that the offsets did not include unallowable gains or losses inequitably distributed to all of the Commission's direct projects. Also, the fisheries disaster awards were direct projects, and the associated costs to manage or oversee these projects represent direct costs that must be excluded from the indirect cost pool and included in the modified total direct cost base in order to bear a fair share of indirect cost. Had the Commission properly handled these costs, the indirect cost rates would have been further reduced. Further, although the Commission contended that the 2 percent fee was applied because funding agencies improperly and arbitrarily imposed limits on indirect cost recovery, (1) it was not forced to accept the funding agencies' offer of the awards and (2) agreeing to use a different billing method does not excuse the Commission from the requirement to consistently apply its normal cost accounting practice.

Additionally, the Commission appears to have misunderstood the context of the column entitled "Accepted by Audit" in table 1 of the report. The column refers to the OIG audit, not the Commission's independent auditors. However, as noted above and contrary to the Commission's assertions, representatives of its independent audit firm stated that its single audits did not include a review of the Commission's indirect cost rate proposal beyond ensuring that the rates charged to federal awards agreed with the rates proposed.

The Commission's response to the draft audit report confirmed that although it used a fixed indirect cost rate with a carry-forward provision, for several years (fiscal years 2002 through 2005) it did not adjust its estimated indirect cost rates to actual rates. As we reported, in 2006 the Commission retroactively adjusted its claimed indirect cost rate for its fiscal year 2006 from 15 to 13 percent. However, that adjustment and those for subsequent years did not properly employ the carry-forward provision, which provides for identifying the difference between estimated and actual indirect costs for an entity's fiscal year and carrying that difference forward as an adjustment to the subsequent fiscal year's indirect cost pool and fixed indirect cost rate computation. A review of the Commission's indirect cost rate proposals for 2007 through 2009 shows that rather than applying the dollar difference to the indirect cost pool of the following fiscal year, it selectively applied either none or a portion of the difference between the estimated

indirect cost rate claimed and the actual rate incurred to the rate computed for the following fiscal year. If there was a residual percentage left, it carried that forward to yet another fiscal year. Rolling forward the difference in rates rather than the difference in indirect dollars and applying this amount forward over several years fails to accurately and timely adjust indirect cost recoveries to actual.

## Conclusion

The Commission disagreed with our conclusion and contended that if NOAA disallowed its indirect cost claims, its work would be jeopardized because it has no other funding source for the administration of its awards.

Nevertheless, we reaffirm our findings. The Commission's response stated that it has taken several corrective actions; however, since our September 2009 exit conference and even since the issuance of our draft report, the Commission has not made sufficient progress in the following areas:

- reconstructing acceptable indirect cost rates for 2002 through the present and identifying a cumulative net carry-forward adjustment,
- developing a revised indirect cost rate methodology,
- negotiating a corrective action plan for past excess indirect cost claims and ancillary fees, and
- negotiating an indirect cost rate agreement with the Department for future years.<sup>41</sup>

## Subsequent Events

The Commission disagreed with our discussion of its proposed indirect cost rates for 2009, and claimed that its 2 percent administrative fee for pass-through funds is an accepted and approved rate. Furthermore, the Commission contended that our report's statement that "we do not accept the Commission's indirect cost rates or administrative fees..." implies that OIG disallows, rather than questions, the costs. (Disallowance is the purview of Department of Commerce management.)

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<sup>41</sup> With regard to developing an indirect cost rate methodology for the future and reconstructing acceptable indirect cost rates that factor in a proper carry-forward provision, we recommend the Commission review the provisions of OMB Circular A-87, attachment E at E, A.3; *A Guide for State, Local and Indian Tribal Governments: Cost Principles and Procedures for Establishing Cost Allocation Plans and Indirect Cost Rates for Agreements with the Federal Government*, ASMB C-10; and U.S. Department of Labor Guidance at <http://dol.gov/oasam/programs/boc/costdeterminationguide/main.htm>, which includes technical assistance, exhibits, cost policy statements, checklists and other indirect cost guidance referenced by the *U.S. Department of Commerce General Indirect Cost Rate Program Guidelines for Grantee Organizations*, dated December 18, 2007, and April 17, 2008.

However, we reaffirm our findings. The Commission used a 13 percent rate for proposing indirect cost for fiscal year 2009. According to data provided in attachment 7 of its response, the Commission proposed a 12.38 percent rate for 2010 based on a 12.37 percent incurred rate for 2009.

As we reported, the Commission's 1996 indirect cost negotiation agreement with the Bonneville Power Administration, which included a 2 percent administrative assessment rate, applied to the period from July 1, 1992, through June 30, 1997, and is no longer applicable. The Commission had no support for its 2 percent rate. It did not account for administrative expenses associated with pass-through funds and therefore could not demonstrate whether the assessment represented either an over- or under-recovery of pass-through administration costs. Offsetting the indirect cost rate by either over- or under-recovered fees is not allowable.

With regards to the terminology we used, not accepting indirect costs is equivalent to questioning them. We did not disallow the costs but rather recommended disallowance and recovery. The authority to disallow costs is reserved exclusively for the federal Grants Officer.

## **Appendix A: Objectives, Scope, and Methodology**

The Commission objected to our statement that the audit was a performance audit conducted in accordance with generally accepted government auditing standards, and contended that based on the audit objectives it should have been conducted under financial audit standards. However, OIG maintains that the standards used were appropriate.

## **Appendix B: Detail of Indirect Cost Audit**

### ***A. The Commission Treated Bonuses Inconsistently***

The Commission disagreed with our findings concerning the methods it used to calculate bonuses for its employees. However, its response underscores a lack of consistency in its treatment of bonuses as direct or indirect costs and acknowledges a change in its bonus methodology before and after fiscal year 2006. Federal cost principles applicable to the Commission require that each item of cost—either direct or indirect—be treated consistently in like circumstances.

The Commission's assertion that it included a portion of the project managers' bonuses in the indirect cost pool because they were providing management oversight of all projects for the benefit of the Commission is inconsistent with our audit findings. In the examples we cited, Commission staff charged all of their time to a direct project; however, their bonuses were charged—in whole or in part—to the indirect cost pool. Under a pay-for-performance system, if an employee applied time exclusively to specific direct projects, the bonus is calculated based on the employee's performance on those projects. The bonus should thus be charged to the direct project, in keeping with the Commission's policy statement that any rewards will be paid from the project/program budget. Charging the bonus to the indirect cost pool would result in an inequitable distribution of the bonus to all direct projects through the application of the Commission's indirect cost rate.

The Commission provided additional information justifying its treatment of select immaterial service costs under the purchase method of accounting; accordingly, we have deleted that portion of the draft report in preparing this final report.

### ***B.1. Necessary and Reasonable Costs***

The Commission gave further details regarding the vehicle it leased for use by a senior official. It supplied some dollar amounts to justify its decision to lease the Lexus but provided no lease-versus-purchase analysis or other documentation in support of the figures. Furthermore, the Commission does not dispute that the official was unable to provide logs to distinguish between official and personal use of the vehicle.

In the absence of the necessary support, we questioned the Commission's inclusion of the total cost of the Lexus as well as the related maintenance, repair, fuel, and insurance costs in the indirect cost pool when the vehicle was clearly provided to the official for both business and personal use. Contrary to the Commission's assertion, our report did not question this official's pay, fringe benefits, bonuses, or perquisites. However, in future deliberations of whether to convert from a mileage-based to a monthly automobile allowance, the Commission should be aware that, given its position as a regional government entity receiving virtually all of its funding from federal and state governments, the personal use of a Lexus, reimbursements for local meals, and U.S. government executive-level pay risks challenge under federal cost principles concerning whether the individuals concerned acted responsibly.<sup>42</sup>

### ***B.2. Direct Cost Charged to Indirect Cost***

While the Commission did not explicitly concur with our finding exemplified by the accounting system upgrade and its event planning practices, it claimed to have taken necessary corrective actions in 2009 and 2010, respectively.

### ***B.3. Inadequate Documentation of Costs***

The Commission agreed that some of its documentation was insufficient. It commented that its process was burdensome and stated that in 2010 it implemented an electronic system to ensure that its rates comply with Commission policies and that required receipts are retained and submitted prior to reimbursement. While the Commission did not explicitly concur with our finding, we accept its corrective actions as concurrence. However, we note that because these actions were not taken until 2010, the changes apply only to the future.

### ***B.4. Undocumented and Excessive Travel Costs***

The Commission stated that its prior travel policy was based in part on federal regulations, but agreed that the policy was not clear. It did not specifically concur with our finding, but noted that it has since updated and finalized a new travel policy applicable to all employees from now on. The policy defines the support required by travel type, assures that travel costs are necessary and reasonable, and requires valid justification for departure from established policies.

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<sup>42</sup> OMB Circular A-87, attachment A at C.2. and C.2.d.



### ***B.5. Entertainment Costs***

The Commission contended that the costs of its annual holiday party constituted employee morale, health, and welfare costs. As such, these costs were not unallowable entertainment expense because the events provided opportunities to thank and reward employees for their service during the year. The Commission further asserted that the auditors did not discuss these issues with its staff during the audit.

Federal cost principles do state that certain expenses related to employee health, morale, welfare, and performance, as well as employer-employee relations, are allowable.<sup>43</sup> However, the costs of entertainment, including amusements, diversions, and social activities, and any costs directly associated with such costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities) are unallowable.<sup>44</sup> The expenses we questioned were related to events identified as holiday or Christmas parties, which were either held at downtown hotels or catered at Commission offices. In all instances alcohol was served. Costs associated with such events are unallowable.<sup>45</sup>

We do not agree with the assertion that our auditors did not discuss this issue with Commission staff during the audit. We specifically requested supporting documentation for numerous holiday party charges in January 2009 and again in March in conjunction with our tests of the Commission's indirect cost rate proposals. We also received a workbook from Commission accounting staff in support of prospective adjustments to the indirect cost rate proposals; the workbook included a spreadsheet titled "Christmas and Xmas Sort."

### ***B.6. Capital Expenditures Charged to Expenses***

Regarding our finding concerning capital expenditures that had been charged to expenses, the Commission asserted that it had done an extensive analysis during the audit to identify assets requiring capitalization in keeping with its \$1,000 capitalization threshold. It further contended that discussion during the audit regarding the Google search engine, which it characterized as software, was brief and inconclusive. The Commission also stated that it had not received a detailed list of questioned costs from the auditors despite requests for such information at the exit conference and in subsequent emails.

In response to our January 2009 request that the Commission correct its indirect cost rate proposals, it identified select equipment charges that should have been capitalized and eliminated from the indirect cost pool. However, our subsequent tests of the March 2009 revised indirect cost rate proposals identified other items, including the Google search engine, that met the Commission's capitalization threshold but that had not been removed from the indirect cost pool. The discussion of the search engine during the audit was brief principally because the Commission's supervisory accountant characterized this item as hardware and agreed that it should have been capitalized and removed from the indirect cost pool. Therefore, we reaffirm our finding.

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<sup>43</sup> OMB Circular A-87 (1995) attachment B at 17 and (2004) attachment B at 13.

<sup>44</sup> OMB Circular A-87 (1995) attachment B at 18 and (2004) attachment B at 14

<sup>45</sup> The Commission excluded the cost of the alcohol as unallowable.

During the audit we had extensive discussions with the Commission's staff regarding items we tested, and Commission staff assisted in locating supporting documentation for those items. We acknowledge that the Commission also requested a list of questioned costs, but the volume of information for this project limited that request.

#### ***B.7 and B.8. Contributions and Lobbying Costs***

The Commission's certification of its indirect cost rate proposal included a statement that to the best of its knowledge and belief all costs included in the proposal are allowable in accordance with award provisions and the federal cost principles of OMB Circular A-87. However, our findings and the Commission's responses demonstrate that certification to be incorrect. First, the Commission provided a newly revised chart of accounts (as response attachment 12) that included a new series of accounts to identify and segregate unallowable costs. The Commission stated that it also reviewed all financial data for 2002 through 2008 and removed potentially questionable items to the new general ledger accounts, but its response did not provide us either revised proposals or supporting documentation. Additionally, the Commission agreed that invoices for legal services were insufficient to identify the portion applicable to unallowable lobbying. It stated that it had discussed with its legal firm the need to identify the time spent on lobbying so that unallowable costs are properly excluded in the future, but this corrective action appears to be limited to instructing the legal firm to supply sufficiently detailed invoices; the Commission made no mention of obtaining the information necessary to identify and exclude lobbying expenses.

#### ***B.9. Bonus Payments Inadequately Supported***

During our fieldwork, we reviewed employee personnel files for evidence of the documentation required to support bonuses as set forth in the Commission's bonus policy. When required support was either incomplete or missing from the files, we gave the Commission an additional opportunity to locate and provide the missing documentation. We questioned bonuses only when neither our search nor the follow-up efforts by the Commission produced the necessary support for the bonuses awarded. The Commission reported that supporting documentation for program managers' and executive staff members' bonuses had not been forwarded to Human Resources for proper filing, but the situation has been corrected. It provided no support for its statement.

#### ***B.10. Salary and Bonus Cost Charged to Incorrect Project***

As we reported, the Commission's time distribution system, if properly implemented, would provide an adequate basis for allocating time among direct projects and indirect activities. However, some labor, fringe benefits, and bonus distributions did not match where staff actually charged their time.

Additionally, the Commission neither had a cost policy statement nor followed a consistent practice for costing bonuses. In some instances, the Commission charged employee bonuses direct and in proportion to where the employee charged his time. In other instances, bonuses for staff charging direct to projects were charged to the indirect cost pool. The Commission needs to develop a cost policy statement that specifically addresses bonuses and follow it consistently.

The Commission's response confirms that it initially classified direct projects, such as event planning and the fisheries disaster projects, as indirect activities. While the Commission contended that it recently received sufficient funding for event planning to establish it as a direct project, that does not change the effects of the initial handling of the project on past indirect cost rate proposals and net carry-forward adjustments. Similarly, the Commission's contention that once it understood the level of effort involved, it directed staff to allocate time to a project account to be offset by the 2 percent administrative assessment neither corrects the improper handling of these projects in the past nor properly accounts for them now.

## **Closing**

During our audit, we found significant deficiencies in every area of indirect cost we tested. The Commission did not submit, certify, or adequately support its indirect cost rate proposals. In addition, its unsubmitted indirect cost proposals and rates were not allowable in accordance with federal guidelines in that (1) implementation of its cost accounting system was inadequate; (2) it had not established an adequate indirect cost methodology or policies, procedures, and controls; (3) its method of distributing costs was inequitable; and (4) it had not adjusted proposed indirect cost rates to reflect actual costs.

Therefore, for the reasons outlined in this appendix, we reaffirm our findings that the Commission did not comply with the minimum requirements necessary to recover indirect costs under federal awards. We also reaffirm the recommendations we made to the NOAA Grants Officer.

(OAE-19467)